# Privatisation and Deregulation in Canada and Britain

Edited by
Jeremy Richardson

The Institute for Research on Public Policy
L'Institut de recherches politiques

# PRIVATISATION AND DEREGULATION IN CANADA AND BRITAIN

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# Privatisation and Deregulation in Canada and Britain

Edited by J. J. Richardson

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# Preface and Acknowledgements

The Canada – UK Colloquium, of which this book is a record, is now an annual event, alternating between the two countries. The Colloquium, at which the majority of the chapters contained in this volume were presented, was held at Gleneagles, Scotland in November 1987. The passage of time has allowed for the updating of most of the papers and the addition of one chapter – that by James Mitchell on *Privatisation as Myth?* in place of David Heald's overview paper, which was unavailable for this publication.

The topic, privatisation and deregulation, was chosen because of its major importance within the Canadian and British economies in the 1980s. Indeed, privatisation and deregulation have now reached global proportions with the concepts having been adopted in both developed and developing countries and even in the Eastern bloc, as the grip of Communism is relaxed.

Despite the almost universal adoption, in Western democracies, of one or both concepts, there is still considerable political and academic controversy over both the merits and the actual implementation of the concepts. This diversity of view is, consciously, reflected in the varied contributions to the Colloquium. For example, the two British overview chapters, by Grimstone and Mitchell, present rather contrasting analyses of the benefits of privatisation. Privatisation and deregulation may be

dominating 'policy fashions', but there is by no means universal agreement on the desirability or execution of this fashion.

Although widespread in their adoption, privatisation and deregulation are somewhat elusive concepts, supported by varying motives. For example, privatisation, even in Britain, seems to have been in large part motivated by simple financial considerations, in that large sums of money were raised for the Exchequer by privatisation. Only as the process continued did more fundamental issues relating to competition arise. Thus we now see (1989) the British Government facing increasing difficulties as the importance of introducing more competition is higher on the political agenda and as other policy considerations – e.g. environmental problems – impinge upon the process. Moreover, as the privatisation process is extended to more difficult industries – such as water and electricity – policy-makers are having to be much more inventive in formulating viable policies. For example, the whole question of the place of the nuclear industry within the privatised sector proved to be so difficult that it had to be retained in the public sector. Similarly, deregulation is not quite as simple as it at first seems. Often deregulation is, in reality, reregulation and raises quite difficult policy questions in terms of the structure of regulatory agencies and the design of regulatory regimes. Roy Croft's chapter on the SIB is a good illustration of the increased complexity of regulation when deregulation is attempted and of the continuing dynamic nature of the process, once begun, and of the continuing need for policy-makers to bargain with the affected interests if successful implementation is to result. In fact the process of introducing effective competition, notwithstanding deregulation , can be a long drawn-out one. For example, in Britain, it has taken seven years for serious competition to British Gas to emerge.

Of particular significance is the strength of non-governmental actors in the processes leading to privatisation and/or deregulation and in the subsequent regulatory process. As Jill Bodkin notes in her chapter, the holding companies and firms were ingeniously moving ahead of the regulators. This suggests that one important characteristic of the *process* by which privatisation and deregulation has been brought about is that it has been one of consultation and bargaining. Even although the policy changes have in some sense been very radical, policy-making and implementing traditions have generally been adhered to. Again, to quote Jill Bodkin, '..... in the Canadian tradition of accommodation, governments were trying to satisfy diverse interests'. In the British case, virtually all privatisations have taken place in the context of carefully constructed coalitions of interests, without any significant interest failing to gain important concessions. The construction of these pro-privatisation coalitions has undoubtedly influenced the nature of the post-privatisation

structures and has almost certainly been an important factor in preventing or delaying the development of truly competitive environments. It has often taken subsequent actions by regulatory agencies to introduce competition, suggesting that 'capture' has not yet been a significant phenomenon.

That there should be variations in the form and practice of privatisation and deregulation – especially in comparative terms, say, between the unitary and federal systems discussed in the Colloquium is unsurprising. In many ways governments are on a 'learning curve of radicalism' and we should not expect that the results of privatisation and deregulation should be without problems. After all, it took many years for the state to develop forms of public ownership and forms of regulation and it will take a similar period for governments – both national and provincial – to 'fine tune' their privatisation and deregulation policies. There is little doubt that much needs to be done to address some of the quite fundamental problems associated with privatisation in its many forms, and to ensure that the benefits of deregulation in the long run really do outweigh the costs. Many of the chapters in this volume provide much cause for concern for governments, if these policies are to be really successful in either reducing costs or improving services, or hopefully, in achieving both. Thus it is true to say that we are in the midst of the creation of a new 'industry' of privatising, deregulating and reregulating. It is to be hoped that this volume, bringing together some observers who are obviously enthusiasts for the process and others who are more sceptical, will contribute to our understanding of the complexitites – and of the benefits and disbenefits – as governments come to grips with a policy fashion which is as yet rather in its infancy. Having discovered that privatisation and deregulation is at least achievable, when ten years ago it was almost unthinkable, it is clear that governments need to put much more analytical capability into devising more sophisticated delivery systems if the public interest is to be safeguarded. As this volume demonstrates, privatisation and deregulation can take place across a wide variety of policy areas and is a *relatively* easy process. Much more difficult is to devise a set of structures, processes and rules which ensure that there are long term gains to consumers as well as to producers. No doubt the Canada – UK Coloquium will return to these important questions on a future occasion!

Many people were involved in organising and running the Colloquium, not least of all the participants listed on the following pages. Acknowledgement is due to the Department of External Affairs in Canada and to the Foreign and Commonwealth Office in London for their support, and and to Imperial Trident Life for providing essential financial support. We are also especially grateful to the Institute for Research on Public

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The usual disclaimer is of course necessary, namely, that the views expressed are the sole responsibility of the authors.

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# PART I OVERVIEW

# 1 The British Privatisation Programme

**Gerry Grimstone**

## Introduction

In 1979, the proportion of British industry owned and controlled by the State was at its highest-ever level. State-owned industries accounted for over one-seventh of total investment in the United Kingdom and were responsible for over 10 per cent of the country's gross domestic product. The industries dominated the transport, energy, communications, steel and shipbuilding sectors of the British economy. What effect has privatisation had? Nearly half of the previously state-owned British industrial sector has now been returned to private ownership. Over 25 billion pounds' worth of shares have been sold, over 700,000 workers have been moved to the private sector, and the proportion of people in Britain who own shares has more than trebled. The success of the programme has given a tremendous spur to privatisation world-wide. And, last but not least, privatisation, together with related policies on ownership, was thought by some to have been a factor in Margaret Thatcher's Conservative Government being re-elected for an historic third term.

Why has privatisation in Britain succeeded? I intend to examine the background to the British privatisation programme, to set out the objectives which have been followed, to describe how the programme was organised and implemented, and to discuss the lessons that were learnt from

experience. I will try and explain why I think that the British process has been so successful and to focus on practicalities not theories. I do not intend to discuss the methods that were developed to protect the national interest (for example 'special' or 'golden shares', regulatory regimes, and subsidy arrangements) nor other routes to private participation such as contracting-out or franchise or concession financing.

## Historical Background

In order to understand the development of the British privatisation programme and how it is now organised, it is important to appreciate the historical background. The state-owned industry sector in Britain was largely created forty years ago. The motivation was *political* (bringing the 'commanding heights' of the economy into state ownership), *economic* (the industries in question needed rationalisation and reconstruction), and *philosophical*. If the Government papers of that period are examined, it will be seen that the industries' founders had high hopes. It was believed that bringing industries into state ownership would instill management and employees with a sense of the public good. It was thought that productivity and efficiency would increase, and that wage demands and price increases would be moderated. Because of this belief in the goodness of human nature, the industries were given a surprisingly light legal framework in which to operate. It was generally thought sufficient to provide for a body of honourable men to run the industries, to place some overall controls on borrowings and investment, and to require the industries to break-even taking one year with another. If the theories had worked, it is clear that nationalisation would have been a startling success.

However, in practice, the performance of British nationalised industries, like others elsewhere in the world, was generally disappointing. Criticisms were continually voiced about their low return on capital employed, their record on prices, productivity and manpower costs, and about the low level of customer satisfaction that they provided.

Although progress in privatisation during the 1979-1983 Parliament may not have been dramatic, it was steady. Seven major sales took place transferring six public sector businesses to the private sector. In addition, there were a number of miscellaneous sales, including various National Enterprise Board/British Technology Group shareholdings. As it happened, the Manifesto was singularly inaccurate as a predictor of events. Shipbuilding concerns were not denationalised and shares in the National Freight Corporation were not offered to the general public, because nobody wanted them. Amersham International, Associated British Ports, Britoil, Cable and Wireless, none of which were mentioned, were sold.

## The Pace Accelerates

The 1983 General Election reinvigorated the Conservative Party's privatisation programme. Radicals within the Conservative Party, who at the time were clearly in the ascendant, had succeeded in including surprisingly detailed commitments on privatisation in the Manifesto and did not make the mistake of first consulting officials about practicality.

> We shall transfer more state-owned businesses to independent ownership. Our aim is that British Telecom – where we will sell 51 per cent of the shares to the private sector – Rolls Royce, British Airways and substantial parts of British Steel, of British Shipbuilders and of British Leyland, and as many as possible of Britain's airports, shall become private sector companies. We also aim to introduce substantial private capital into the National Bus Company. As before, we will offer shares to all those who work in them. We shall also transfer to the private sector the remaining state-owned oil business – the British Gas Corporation's offshore oil interests. In the next Parliament, we shall seek other means of increasing competition in, and attracting private capital into, the gas and electricity industries.

The stage was set for a dramatic acceleration in the pace and breadth of the privatisation programme. 'Sustaining momentum' became a key concept and the Prime Minister took a continuing interest in ensuring that the programme remained on track. The appointment of John Moore, first as Economic Secretary then Financial Secretary to the Treasury, gave the programme an important boost. His main responsibilities as a Treasury Junior Minister were the Inland Revenue and privatisation, and he became a determined advocate of both privatisation and wider share ownership.

It had become clear for some time that the intellectual and philosophical case for privatisation was going by default. Both proponents and critics tended to view it in narrow financial terms and what debate there was on the merits of the programme was often conducted in terms of whether or not the family's silver was being sold. The intellectual high ground needed to be grasped if the programme was to carry conviction in economic and political terms and to be seen as other than a purely financially-orientated exercise. A series of speeches made by John Moore from November 1983 onwards gave the programme an intellectual coherence that it had previously lacked, and it became increasingly clear that a well-organised programme could bring political as well as economic success.

## The Programme's Objectives

Success was helped by the realisation that a privatisation programme could fulfill other objectives than purely that of increasing efficiency. Indeed, increasing efficiency did not necessarily have to be the main priority, a discovery which was to create later tensions. As presently organised, the British programme, in common with other programmes elsewhere, has the following key objectives:

- to increase efficiency through competition, deregulation, or other means;
- to raise finance which can be used to fund other expenditure priorities, to reduce borrowing, to reduce taxation, or any combination of these;
- to encourage employees to own shares in the company in which they work;
- to boost the level of share ownership in the general economy;
- to strengthen the capital market;
- to gain domestic and international prestige.

Judged by these objectives, the programme has clearly been successful. Around twenty major companies and a number of smaller enterprises have been sold. Millions of new investors have been introduced to the stock market through the programme and there has been a high level of employee participation. One in five of the adult population of the UK is now a shareholder compared to one in ten Frenchmen and one in twenty Japanese. The performance of privatised companies has improved and, for example, the profits of British Aerospace have trebled, those of Cable & Wireless are up sevenfold, Amersham International's have doubled, Jaguar's are up a third and the National Freight Consortium's have increased seven-fold. The combination of freedom from statutory and bureaucratic constraints, strong balance sheets, progressive elimination of internal inefficiencies, and generally favourable economic conditions have done wonders for the companies concerned.

Although the commercial and political arguments in favour of privatisation now seem clear-cut, it was easy for opponents in the early stages of the programme to argue that, financially, the programme was misjudged. I have mentioned the 'selling the family silver' argument. Was there a case in a narrow financial sense, for keeping profitable industries in state

ownership? It was not clear that selling profitable industries would, in the longer term, be of financial benefit if the proceeds from selling equity were ignored. However, subsequent work indicated that the combination of increased tax payments by the companies as their profitability increased once they were freed from government constraints, interest savings on debt not borrowed by the government as a result of selling equity, dividends from residual shareholdings where these have been temporarily retained, and the funding of future investment requirements in the private sector rather than by the state was likely to produce a continuing cash benefit to the Exchequer. Privatisation could be justified on financial grounds alone although it was rarely politically wise to do so.

## How To Do It

Our experience in Britain has shown that wishful thinking is not sufficient in itself to create a successful privatisation programme. A strong political will, and tight central control and co-ordination, are essential. Nationalised industry policy in Britain has always been the responsibility of HM Treasury. The reasons for this are not hard to fathom. Whilst it was appropriate for individual sponsoring Departments such as the Departments of Transport and Energy to be responsible for the day-to-day sponsorship of individual nationalised industries, sponsoring Departments were not happy to see any other individual sponsoring department exercising overall control. It made sense for the Treasury to seek to occupy the central policy vacuum that this created, both because of the nationalised industries' public expenditure impact and their effect on macro-economic policies. Controlling both policy and the purse-strings put the Treasury in a dominant position. Because privatisation policy was seen as an an adjunct of nationalised industry policy in its early days, it was natural for the Treasury to take on responsibility for privatisation policy and the overall co-ordination of the programme.

In practice, this approach produced clear benefits. The Treasury's desire for revenue, whilst not unduly emphasised in public, would sustain the programme's momentum, and the Treasury's innate abilities could be deployed to advance a policy that was central to the Government's thinking. It was also clearly beneficial to create a small caucus of officials at the centre who would be involved in each and every privatisation. This eased technology transfer between Departments and helped to overcome the inertia that tended to seize sponsor Departments when privatisation threatened to break up much-loved bureaucratic fiefdoms. It also allowed discipline and

cohesion to be maintained. Given that the market viewed the sales as a programme, it behove the Government to do likewise.

## Achieving Privatisation

Achieving successful privatisations is a long and complex process. Three separate strands of activity can be identified:

- legal and constitutional changes;
- re-orienting the company's business, systems and management towards the private sector;
- selling the company.

The necessary steps may take between two and three years to complete and expert advice is normally needed if a series of sales is to be completed successfully. The obstacle and problems that need to be overcome if sales are to be achieved should not be under-estimated.

An important initial task is to identify candidates, to ascertain what changes are necessary if they are to operate as successful private businesses, and to decide how and when they should be sold. A co-ordinated action plan must be drawn up. The credibility of the programme must be established early on if momentum is to be sustained and investor interest generated. This points to doing the easiest sales first e.g. selling companies trading on the fringe of the public sector who already have the necessary private sector orientation. To take industries out of the heart of the public sector and to re-orient them is a lengthy process. It must never be forgotten that unlike nationalisation, privatisation is a two-way process: Governments may want to sell but someone must also want to buy.

Methods of sale in the British privatisation programme have been determined by the programme's overall objectives and by practicalities. Because of the desire to spread ownership widely, public offerings of shares are the preferred choice if they can be achieved. Failing this – and a public offering is a severe test for a company – employee buy-outs have been welcomed provided that the funds are available and the company's cash flow can support the necessary leverage. The most difficult sales to bring to a popular conclusion are sales to corporate purchasers particularly if overseas buyers are involved. The politics of privatisation are such that domestic investors normally have to be given preference although minority sales overseas can be an important factor in bringing an otherwise domestic sale to a successful conclusion.

## Capital Market Effects

Turning now to the capital market effects of privatisation, two main positive impacts can be distinguished:

- privatisation can lead to a widening of the capital market by introducing new investors both domestic and international;

- privatisation can lead to a deepening of the market by introducing mature companies with a strong market position.

Both these effects, which are inter-related, are clearly advantageous.

As an illustration of the first effect, privatisation in the United Kingdom has clearly led to personal savings being switched into the stock market from other forms of investment. The sale of British Telecom in 1984 was the first privatisation anywhere in the world specifically designed to have widespread popular appeal. Prior to then, there were many who doubted that the British general public could be taught to buy shares via privatisation. The proportion of shares owned by the general public was decreasing, and attracting even 50,000 people into a privatisation offering was reckoned to be good going. Yet the British Telecom sale attracted over two million applicants of whom around half had never before owned shares.

How was this done? The British Telecom sale was five times larger than any sale that had previously been attempted and was the first to be marketed on a wide scale to the general public. It had been clear for some time that existing share-selling techniques were not capable of creating a new breed of shareowners. Stockbrokers generally were happiest selling shares to their existing clients and, in consequence, if shares were to be sold widely, new distribution channels needed to be created. The vendor would have to go over the heads of the normal intermediaries both by motivating a more lively salesforce than traditional stockbrokers and by selling direct to prospective shareholders. No vendor was more suited than the Government to take on the challenge.

Why was it so popular? British Telecom combined features of both a utility and a high technology business which made it ideally suited to inexperienced shareholders. The sale was advertised widely in both the press and television, and generous commissions were paid to financial intermediaries. Small shareholders were, at the government's expense, given the added attraction of a one for ten free loyalty bonus issue of shares if they held their shares for more than three years or, alternatively were given discounts off their telephone bills. The sale captured the public's

imagination, proved with the benefit of hindsight to be significantly underpriced, and was both a popular and political success. It marked the emergence of popular capitalism in the UK and showed that the largest privatisations, if properly handled, could be successfully absorbed by the capital market. Prior to British Telecom, to raise £500 million in a single transaction was reckoned to be good going. The British Telecom sale raised nearly £4,000 million paid by instalments over a three-year period.

It was suggested earlier that privatisation can deepen as well as widen a country's capital market. This arises because it is often a country's dominant business that were previously nationalised and brought into state ownership. They were brought into the state sector because of their position in the economy, their strategic importance, or their size and market dominance. It is these very characteristics which, on privatisation, enable them to give depth to a stock market and to provide ballast to what may have otherwise been an unduly speculative environment. Some speculative interest is a necessary component of all capital markets: too much deters the serious investor.

The experience of Britain and other countries is that privatisation – contrary to the original expectations of economists and others – can create its own market capacity. There are a number of reasons for this.

First, the equity that is being sold is normally a good quality and represents an attractive investment opportunity. Purchasers gain comfort from the fact that the vendor is a government and have learnt by experience that governments are risk-averse when it comes to privatisaitons. Success is valued highly, which is no wonder given privatisations' invariably high profile.

Secondly, a government that is raising finance by selling equities will borrow less for a given public sector financial deficit than it would do otherwise. A government's total demand on the capital market may therefore be unchanged by a privatisation programme. The equity of utilities that hold a dominant market share either via operating a natural monopoly or otherwise can closely resemble debt in its financial characteristics and thus may be accommodated in that portion of an investor's portfolio previously reserved for fixed income securities.

Thirdly, and this point is often overlooked, even a single privatisation may create a company that is a material component of a stock market's index. Those investors who attempt to match their portfolios to the main constituents of a country's capital market must buy privatised equity if they are to maintain their relative position. Some privatised equity – for example that of a national electricity or telecommunications equity – also gives good exposure to the totality of economic development in a particular country and this may be valued by an investor.

Fourthly, it should also be remembered that governments who are selling equity become interested in the operations of the equity market and implicitly or explicitly, take steps to strengthen the market. Traditionally, of course, governments only operated in the debt market whereas the equity market tended to be left to market practitioners. This is now no longer the case in countries which are pursuing successful privatisation policies. It is also true that the same political philosophy which produces privatisation is also likely to encourage market liberalisation and de-regulation. Privatisation and the growth of London as an international financial centre have gone hand in hand.

Despite the large proceeds raised from privatisation sales in Britain in the last five years, the total net issues of ordinary shares in London has reached record levels. It is clear that despite the heavy demands that privatisation has placed on the London market, private issuers have not suffered. New capital-raising has reached record levels. There has been no crowding-out of private investment by government sales and this is important if the overall success of a privatisation policy is to be maximised.

In order to achieve capital market benefits, a sophisticated marketing programme must be created to maximise interest from all classes of investors. This will normally be extremely cost effective. Not only can such a campaign benefit proceeds and the commercial image of the company that is being sold, but it can also provide an opportunity to project a country's general economic development and financial status. Many countries would like to have a privatisation programme. Few can assemble sufficient determination, expertise, and credibility to achieve one.

## Lessons To Be Learnt

Although the British privatisation programme is a popular success, mistakes have been made and lessons have been learnt by experience. In the early days of the programme, sales were treated as one-off individual market transactions and no real attempt was made to co-ordinate the programme nor to capture the public's imagination. Market professionals consistently under-estimated the power of privatisation to attract retail interest and persisted in offering too few shares too cheaply to the British public.

Because demand for privatisation can be an order of magnitude greater than is commonly found in private sector sales and is not always easy to predict in advance, offer structures are needed which can cope with unexpected demand that materialises in the offer period. The Cable and Wireless sale in December 1985 which was conducted by Schroders for the

British Treasury and which was at the time the world's second-largest ever equity sale, pioneered a new technique – flexible clawback – which permitted shares that had been provisionally placed with financial institutions to be clawed back and sold to the public if greater than expected demand materialised. Subsequent sales have followed suit. As a further development, the BAA sale introduced the partial tender concept which combined a fixed price offer to the general public with a tender offer aimed primarily at the financial institutions. It thus encouraged wider share ownership whilst at the same time boosting marginal proceeds.

Novel structures are needed for privatisations because of the sales' unique characteristics. Privatisations differ from all the other public offerings, particularly in terms of political sensitivities, size, investor interests, and complexity of objectives. The luxury of treating them as purely financial transactions is simply not available.

A vendor conducting a series of sales is in a very different position from one involved in a single transaction. Such a vendor is likely to maximise benefits if the sales are conducted as a programme in terms of their presentation, timing, and organisation. Instead of seeking to maximise financial advantage sale-by-sale, it is often sensible to create a 'band-wagon' effect by encouraging the continuing perception that the sales are good value and that to miss them means foregoing a valuable opportunity. If this is done, demand will flow from sale-to-sale and will allow larger and larger sales to be accomplished on tighter-and-tougher terms.

If a privatisation programme is to be pursued, it is important that the case for doing it is deployed publicly. Whether or not increasing efficiency, spreading ownership, or raising finance are the objectives, the intellectual and economic justification for the programme must be coherently presented. If the emphasis for the programme is seen as being primarily political, problems will result. Not enough attention was paid to this aspect in the early days of the British programme.

It is also important that the critical participants in the programme are identified early on and dealt with in the most satisfactory fashion. Key groups normally include the following:

- the general public as taxpayers, customers and voters;
- the employees of the firm being privatised;
- the management of the firm being privatised;
- prospective investors;
- commentators;
- opponents of privatisation

Fair pricing which balances the needs of the taxpayer and the investor, voucher offers for customers, free shares for employees (not least to negate Trade Union opposition), retaining the privatised company's corporate structure, widespread distribution of shares, full disclosure of information, and careful attention to detail may all be necessary if a successful sale is to be achieved.

## What Next?

The British privatisation programme has gone further and faster than even its most ardent supporters expected. To raise £5,000 million pounds a year on a continuing basis is now seen as unremarkable. The British Gas sale attracted five million applicants and was the world's largest-ever equity transaction. In the first half of 1987, three major sales – British Airways, Rolls Royce and BAA (which owns and operates Britain's major airports) – followed in quick succession, with the record £7 billion sale of BP shares completed at the time of the 1987 Stock Market crash. Since then, The Rover Group and British Steel have both been successfully privatised.

In political terms, few policies can claim the benefit of privatisation and be attractively presented in terms of privatisation's ability to increase industrial efficiency, raise money, boost ownership amongst employees and the wider general public, and carry domestic as well as international prestige. Provided the relevant interested groups are clearly identified at an early stage, and are satisfied, everybody seems to win.

What lessons should be learnt from all this? First, privatisations are not merely financial transactions, and opportunities will be lost if they are treated as such. Secondly, the case for the programme must be argued effectively and enthusiastically. Thirdly, involving employees and the general public to the greatest possible extent not only helps provide market capacity, it can create genuine popular success. And the overall effect of the programme to date, other than its startling impact on ownership patterns and company performance? The last word should rest with Nigel Lawson, then Chancellor of the Exchequer, who had done so much to ensure the programme's successs. He aptly described the outcome of the BT sale as follows:

> '2 million people have put their money on the table. And they have put it on the blue square.'

It is quite coincidental, of course, that blue is the traditional colour of the Conservative Party.

# 2 Britain: Privatisation as Myth?

**James Mitchell**

## Introduction

'Privatisation' came into common parlance during the 1980s to describe a variety of policies pursued by governments across the political spectrum. Its use suggests that a common thread runs through such diverse policies as selling council houses to sitting tenants in the United Kingdom, selling de Havilland to Boeing in Canada and leasing hotels in Sierra Leone to the management. The forms it can take are many and even enthusiasts for privatisation accept that it is almost impossible to attribute a clear or definite aim to any one of the governments involved in privatisation.[1] Kay et al identify three interrelated strands of policy: denationalisation – the sale of public sector assets; deregulation – the opening of state activities to private sector competition; and tendering – the contracting-out of public provision to private firms.[2] Heald adds a further element to the list by including the substitution of user charges for tax finance, giving examples such as increasing local authority housing rents and charges for entry to museums.[3]

Essentially, privatisation involves moving responsibilities out of the public sector. But this is a very wide definition and in very few cases has the state entirely abrogated responsibility. Through 'golden shares', regulatory agencies, provision of a protective environment (including prevention of

competition), the state remains involved. Perceiving privatisation as the withdrawal of state involvement is both crude and inaccurate. The political high profile of privatisation is an important dimension. It may simply be that privatisation has certain connotation which governments wish to convey while pursuing some other objective, such as efficiency or efficacy. This would not devalue privatisation as a term so much as underline the importance of rhetoric and myths in politics. It is important, however, to separate the myth from reality. Consideration of privatisation as a *laissez faire* or Schumpeterian policy demonstrates that though elements of each exists, expediency has been paramount in the programme.

## Origins

As Heald has pointed out, the term privatisation did not appear in dictionaries in 1979 yet it dominated the political agenda eight years later.[4] The United Kingdom was the 'pioneer' of privatisation[5] where it has been seen as a component of 'Thatcherism', another potent but imprecise term. Indeed, privatisation cannot be understood without some appreciation of Thatcherism.

Policies which might be described as privatisation were certainly pursued prior to Mrs Thatcher becoming Prime Minister, but supporters and opponents alike have presented the privatisation programme as a sharp change in approach. Oliver Letwin, who served in Mrs Thatcher's Policy Unit in Downing Street before heading the Privatisation Unit of Rothschild's Merchant Bank, has described these instances as 'no more than the pre-history of privatisation'.[6] Jenkins describes Thatcher as the 'first anti-socialist to come to power in social democratic Europe' and to have made nationalisation almost inconceivable.[7] Similarly, Gamble had described privatisation, or denationalisation as he prefers to call it, as the almost tangible evidence of the Thatcher Revolution.[8] Where Jenkins and Gamble concur with Letwin is in seeing Thatcherism as revolutionary. There may have been examples of privatisation in the past but they were not pursued as part of a coherent programme aimed at rolling back the state. An alternative view is that the policy of privatisation involves a considerable element of expediency (wrapped up in radical rhetoric) which evolved incrementally, a description which fits Thatcherism in general.

What emerged in the 1970s was not so much an intellectually coherent package of ideas waiting to be implemented by a radical Conservative Government but a combination of growing doubts about aspects of the social democratic consensus which coincided with, and was partly caused by, an economic crisis. The energy crisis, high levels of inflation and lengthening unemployment queues did far more to shake the post-war

consensus than the activities of right-wing think tanks. The response of the Labour Government to these externally imposed crises was a prelude to the action of the Thatcher Government; as Peter Riddell has remarked, if there was a Thatcher experiment it was launched by Denis Healey.[9] The extent to which the Conservatives helped create or merely responded to a growing swell of public anxiety and hostility to nationalised industries may be disputed but that anxiety certainly existed. Britain was a declining power operating within an international economy and facing severe problems.

It might be though that right wing think tanks and intellectuals lobbied the Conservatives to adopt privatisation. In fact, Lord Harris, chairman of the *Institute of Economic Affairs*, has admitted surprise at the speed and extent of the programme and maintains that the IEA had very little input.[10] Although it is standard practice in the study of the 'New Right' to consider the views of bodies such as the IEA, Adam Smith Institute, Centre for Policy Studies, Social Affairs Unit and the influence of individuals such as Friedman and Hayek,[11] little attempt has been made to assess the actual role they have played in contemporary politics. Whatever these institutes did, they can hardly be described as the vanguard of a coherent and comprehensive privatisation programme.

There is little evidence of a concerted Conservative campaign advocating wholesale privatisation during the crucial period of the last Labour Government, when a reversal occurred with electoral support for privatisation outstripping support for nationalisation for the first time (Table 1).

**Table 1**

Attitudes to nationalisation, 1964-83, % favouring

| | Nationalisation | No Change | Privatisation |
|---|---|---|---|
| 1964 | 28 | 51 | 21 |
| 1966 | 29 | 49 | 22 |
| Feb 1974 | 28 | 47 | 25 |
| Oct. 1974 | 32 | 46 | 22 |
| 1979 | 17 | 43 | 40 |
| 1983 | 18 | 40 | 42 |

Source: *Heath, Jowell and Curtice, 1985, p.132.*[12]

Although the climate of opinion doubted the efficacy of state involvement, and the nationalised industries were a major focus of dissatisfaction,

proposals being made generally did not amount to privatisation. A significant contribution to the debate was a book written by John Redwood entitled *Public Enterprise in Crisis*. Redwood became head of the Prime Minister's Policy Unit from 1983 to 1985 and, as described on the cover of Letwin's book, was actively involved in the establishment of the UK privatisation programme. In Redwood's book he made out the case for 'so far and no further' with regard to nationalisation, rather than 'rolling back the state'[13] and he advocated a series of reforms which fell far short of the privatisation programme he was to be involved with a few years later (Table 2 for summary of proposals). A striking comment was that his limited proposals were less problematic and more democratic than denationalisation. The book was published in 1980 and was written after the election of Mrs Thatcher. It might be argued that Mrs Thatcher failed to implement a radical programme in her first term as she had not consolidated her position in Cabinet, the civil service and the party. But this does not explain why the ideas for privatisation were absent from Redwood's book and elsewhere.

**Table 2**

Summary of possible solutions contained in John Redwood, *Public Enterprise in Crisis* (1980).

*Industries where asset sales are possible*
National Freight Corporation
Electricity showrooms
Gas Showrooms
Rolls Royce, ICL, Ferranti and other smaller NEB companies
Cable & Wireless
BNOC (oil assets and exploration)
BP
British Airways
British Aerospace
British Transport Docks Board

*Industries that can be self-financing subject to monopoly controls*
Gas distribution
Electricity generation and distribution
Coal mining
Telecommunications
Post

*Industries that need a cash limit regime and reorganisation*
BSC
BL
British Shipbuilders

*Industries where a contract may be necessary*
Bus transport
Rail transport
Metro rail transport

## Free Market Objectives

The first official statement of the objectives for privatisation was not made until November 1983.[14] The 1983 speech by John Moore followed sales of public assets including Amersham International, half of Cable and Wireless, Britoil and British Aerospace and part of British Petroleum in total valued at over £2 billion. This statement by Moore, as Financial Secretary to the Treasury, was clearly a case of *post hoc* rationalisation. Two years later in another major speech, Moore set out the achievements of privatisation in which there was a discernible change of emphasis with business efficiency demoted from its position of primacy to just one of a number of objectives.[15] Letwin refers to the shift of emphasis in the Government's rhetoric manifested in the speeches [16] separated by two years and sales, including Telecom, valued at almost £5.5 billion. Raising revenue through 'selling the family silver', as former Conservative Prime Minister Harold MacMillan portrayed privatisation, permitted the Government to finance current expenditure, and avoid unpopular cuts. This was particularly important in the light of difficulties it had in controlling public expenditure, and is discussed more fully later. Veljanovski has listed eight objectives of privatisation [17] and Letwin has listed nine.[18] Combining these sets of objectives it is possible to identify three general types: free market objectives, revenue raising, and changing attitudes and values.

Government supporters emphasise the free market aspects of the programme, usually prefacing their remarks with the mandatory genuflections in the direction of Adam Smith. This seems strange given the priority Smith attached to competition and his acceptance of state intervention.[19] Smith's name rather than his ideas tend to be invoked by supporters of privatisation. Hayek asserted that the price system would fulfil its function 'only if competition prevails'[20] although his concern was less with creating business efficiency than with avoiding the threat to

liberty which he believed was a consequence of state intervention. The lack of competition has been a major criticism of the privatisation programme. In 1986, Kay et al, noted that the conflict between the aims of liberalisation and competition had turned into a rout.[21] A number of free market supporters, including the Institute of Economic Affairs, have focussed upon this failing, as they see it, of privatisation. While applauding aspects of the programme, doubts about whether privatisation has brought about the 'most dramatic restoration of the market framework', as Nigel Lawson maintained, were expressed by Alan Budd.[22] Concern at 'perhaps the most profound weakness of the British privatisation programme'[23] led the IEA to produce a book, *Privatisation & Competition: a market prospectus (1989)* setting out frameworks for competition in a number of areas.[24]

Another IEA publication has suggested the the 'Big Bang' did not deregulate the City of London but has led to new 'over-regulation'.[25] Charles Goodhart, a former chief adviser to the Bank of England, points out that the rule book of the Securities and Investments Board 'weighs in at 4·5 lbs, and it has been revised and amended so many times in the last 12 months that the exercise of keeping one's red folder in correct order and shape has reached major proportions'.[26] A further criticism, made by Veljanovski, is the lack of the threat of a hostile takeover bid – 'the single most potent force in the capital market' – which seriously undermines the claim that greater efficiency will follow from privatisation.[27] Responding to criticisms, the Government's proposals for the privatisation of electricity included a complex structure for the industry.[28] But Government policy has already included the privatisation without much competition of major industries including telecommunications and gas, and has permitted the take-overs of British Caledonian by British Airways and Britoil by BP. Competition appears as an afterthought – although coming too late in many cases – just as identifying the objectives of privatisation was.

## Adopting Privatisation

Margaret Thatcher has been presented as a 'mobilizing Prime Minister'.[29]. In a Conservative Party publication celebrating the tenth anniversay of the first Thatcher victory, privatisation, involving a 'fundamental political change', was described as the 'Jewel in the Crown' of the first ten years.[30] Yet, in terms of the policy making process, consideration of the evolution of the policy demonstrates that it was conceived and developed incrementally rather than 'rationally'.

Privatisation did not even rate a mention in the Conservative Party manifesto for the 1979 election, although it was to appear in 1983 and 1987 manifestos.

Veljanovski argues that the reason that there was no 'mission to privatise' in the early years was due to fears that it was seen as a hard option and would be unpopular.[31] But as he shows later, the privatisation of British Telecom was arrived at following a series of measures aimed at liberalising telecommunications and 'grew out of the government's apparent inability to allow BT to raise capital in the market place, free from the difficulty that investors would see their loans as government backed'.[32]

Blackstone and Plowden's study of the Central Policy Review Staff confirms Veljanovski's view that the financing of the nationalised industries' investment was the single most important factor responsible for the policy. The CPRS was engaged in a major study of nationalised industries in 1981/2. In the light of Conservative criticisms of ministerial interference with nationalised industries, it is perhaps ironic that the Think Tank tried to devise ways of increasing ministerial control. The origins of the CPRS study was Mrs Thatcher expressing 'extreme dissatisfaction both with the performance of the nationalised industries and with the increase in their demands for cash'.[33] The unpublished CPRS report was completed in July 1981. It proposed smaller, higher-calibre boards with a majority of non-executive directors appointed from outside the industries, and the establishment of 'Business Groups' headed by someone from the private sector, in each Whitehall Department, helping civil servants devise strategies and monitoring the industries. Mrs Thatcher is reported to have 'thought the report excellent, and said so'[34] but it was never implemented and the Government embarked on a sustained programme of privatisation not long after its publication.

Despite the retrospective presentation of privatisation as some coherent, well thought out plan of action, it was a programme which the Conservatives staggered towards as they encountered difficulties in financing capital expenditure programmes, allied with a recognition of the potential of the populist nature of privatisation. It had the great benefit of being easily articulated with the consistent message that intervention did not work – the 'most potent and widely disseminated idea in the political economy of the New Right'.[35] Additionally, in designing privatisation, the Government succeeded in squaring all the interests which might have caused difficulties with implementation. Management, the workforce, customers and the City were effectively bought off, at least at the point of privatisation. Implementation of the process might have been hampered by opposition from these quarters.

The terms offered to management were favourable. In one respect, managements had the best of both worlds with privatisation – relative

freedom of interference from government (although government reserved powers through 'golden shares' and regulatory bodies) without being left to compete in a hostile environment. The views of management were influential in the form that British Telecom and British Gas took. Both companies were candidates for being split up and sold as competing divisions. Sir George Jefferson and Sir Denis Rooke successfully argued against this for BT and British Gas respectively. It has been argued that this appeasement of management involved a missed opportunity for structural reforms of the industries.[36] Amongst the senior managers of nationalised concerns, Rooke was one of the most critical of privatisation. On the other hand, Jefferson had been appointed partly because of his sympathetic attitude towards privatisation. The principal motivation appears to have been a desire of management to retain control of a large concern with a dominant position in the market, rather than opposition to privatisation.

Workforces of all privatised industries were given special privileges at the time of sale. In almost all cases they were allocated free shares, and for other shares purchased additional free shares were matched by government, although these could not be sold immediately. Preferential access to buy additional shares was also given to the workforce up to a given amount, although in the case of Telecom there was no limit placed on employees. The proportion of employees taking advantage differed from industry to industry, ranging from 19% in Jaguar (where only the preferential option was available) to 99% in British Gas, Amersham International and Cable and Wireless[37]. British Telecom employees were each offered 54 ordinary shares worth £70.20 at sale price plus a matching share of two ordinary shares without charge for each share bought by the employee up to 77 shares, plus a priority offer to employees and pensioners. Around 96% of employees accepted the free shares and almost 80% bought matching shares and over 25% bought shares under the priority offer. As Letwin maintains, this constituted a 'stealing of the clothes of the left by the right'.[38] Beyond the immediate sale of the industries, a variety of employee share schemes were developed by the privatised companies and in some cases more than one type of scheme operates. It is too early to judge how successful these have been.

Privatisation took the form of buy-outs by the management and/or workers in a few instances. In 1982 the National Freight Corporation was sold to a consortium of managers and employees while the government agreed to pay the deficiencies in the company's pensions scheme. As the sale price was £53.5 million and the pension fund deficiency was £48.7 million, the government proceeds amounted to £4.8 million.[39] The over-subscription demonstrated that there was a demand amongst the workforce for the preferential treatment offered by government. The value of the

shares increased dramatically – by 1988 by over thirty times.

In cases such as British Gas, the customers were guaranteed a minimum of 200 shares. All gas customers were sent a letter as part of the largest direct mail shot in Britain. But more important have been provisions to protect customers from concerns which have monopolistic, or near monopolistic position in the market. The aims of commercial freedom and protection of customers will not always be compatible. Protection of customers is catered for with regulatory agencies although how useful they will prove to be in the long run is open to question. Agencies such as the Office of Telecommunications (Oftel) for British Telecom and the Office of Gas (Ofgas) for British Gas attempt to ensure that competition is conducted fairly and that the industries abide by the terms of their licences. Bryan Carsberg, Director General of OFTEL since 1984, has described the promotion of competition as his highest priority, as he sees this as synonymous with promoting the interest of customers.[40] The National Consumer Council has argued that a single public utility commission would be of more benefit to consumers because they felt this would allow for cross-comparisons, it would be more cost-effective, it would lessen the possibility of a commission being 'captured' by an industry and it would be able to take strategic decisions. The consumers, as consumers not as purchasers of shares, have arguably been least catered for in the process of privatisation.

The City, along with the Government, gained most from privatisation. Quantifying the benefits to financial institutions would be difficult indeed and it is far simpler to identify the roles the City has assumed in the process. According to Wiltshire, financial institutions had six roles in the process; general consultant and advisers on broad elements of the policy; consultants to specific areas of government including the Treasury, sponsoring department and the enterprise concerned; underwriters; stockbrokers; merchant bankers; and makers of overseas arrangements for flotations. Additionally solicitors have been involved in each case.

## Revenue Raising Objectives

Norman Barry maintains that privatisation as part of the liberal's economic creed has 'nothing to do with raising money to reduce the budget deficit' because this could only be achieved permanently by cutting public spending.[41] But as Sir Leo Pliatzky, former Second Permanent Secretary at the Treasury, has remarked, the Treasury was 'not at all indifferent to its financial advantages to the Exchequer'[42]. The classic liberals' disappointment with privatisation is that raising money has been a more obvious feature than creating a competitive free market. Two major

sources of revenue for the Conservatives since 1979 have come from North Sea Oil and the privatisation programme. The proceeds from privatisation in the first term were less than £500 million a year but by 1985/86 the annual total was greater than that for the whole of the first term. Partly, this reflects the use of instalment payments and fixed repayment schedules spread over a number of years, but largely this was due to the increase in number and scale of the programme.[43] Proceeds from privatisation were crucial to budgets presented from 1983. Despite the drastic fall in oil prices in 1985/86 (from $28 to $15 a barrel), the 1986 budget included a reduction in the basic rate of tax and a series of other measures – unlikely to have a major reflationary effect but sufficient to appear to be doing something in the lead up to election year. The budget presented three months before the General Election the following year, while oil prices still languished at low levels, again offered the Government considerable scope for tax cuts in an electioneering budget.

A matter related to receipts has been accounting methods. The rhetoric of the Conservatives in the late 1970s had been that of reducing public expenditure.[44] A White Paper in March 1980 stated that the Government intended to 'reduce public expenditure in volume terms over the next four years'.[45] The Government had inherited the Labour Government's commitment to increase defence spending by 3% a year in real terms as well as increase spending on health. Additionally, the rising levels of unemployment meant that the aim of reducing public expenditure was more difficult to achieve. Privatisation proceeds could either be accounted for as negative expenditure and therefore appear to reduce public expenditure levels or as financial flows. Although there is no difference in practice, the presentational difference had politically symbolic importance, especially when the trend in the ratio of public expenditure to GDP was running embarrassingly against the Government's aims. By presenting receipts from privatisation as 'negative expenditure' the Conservatives attempted to hide the extent to which they were failing in their stated aims. As Pliatzky has noted, this 'did much to reconcile the right wing of the party to the compromises on public expenditure'.[46]

By 1985/86 when the ratio began to fall, even excluding privatisation proceeds, the presentational problem receded. The emphasis in the Treasury on the ratio *excluding privatisation proceeds* reflects a 'feeling that it is no longer quite so important politically to treat privatisation as a substitute for public expenditure cuts, and also a growing confidence that the objective of reducing public expenditure as a percentage of GDP can be achieved without bringing privatisation receipts into the reckoning'.[47] Of course, this did not remove the attractions to the Treasury of the receipts of privatisation.

**Table 3**

Money Raised by HM Government, and Costs of Public Offers for Sale

| | Cash Raised (£m) | Cost (£m) | Date of Sale |
|---|---|---|---|
| British Petroleum | 564 | n/a | Jun. 1977 |
| British Petroleum | 290 | 7 | Nov. 1979 |
| British Aerospace | 50 | 6 | Feb. 1981 |
| Cable & Wireless | 189 | 7 | Oct. 1981 |
| Amersham International | 65* | 3 | Feb. 1982 |
| Britoil | 637 | 13 | Nov. 1982 |
| Associated British Ports | –34* | 3 | Feb. 1983 |
| British Petroleum | 566 | 10 | Sept. 1983 |
| Cable & Wireless | 275 | 5 | Dec. 1983 |
| Associated British Ports | 52 | 1 | Apr. 1984 |
| Enterprise Oil | 392 | 11 | Jun. 1984 |
| Jaguar | 294** | 5.5 | July 1984 |
| British Telecommunications | 2,626*** | 152 | Nov. 1984 |
| British Aerospace | 363 | 18 | May 1985 |
| Britoil | 449 | 15 | Aug. 1985 |
| Cable & Wireless | 602 | n/a | Dec. 1985 |
| British Gas | 7,720**** | 172 | Dec. 1986 |
| British Airways | 900 | 30 | Feb. 1987 |
| Rolls Royce | 1,080 | 29 | May 1987 |
| BAA | 1,281 | 41 | July 1987 |
| British Petroleum | 5,725 | 114 | Oct. 1987 |
| British Steel | 2,500 | n/a | Dec. 1988 |

* including debt repaid/extinguished
** raised by British Leyland Plc
*** net of pension fund liabilities retained by B.T. Corporation
**** including net new debt created

Source: *Privatisation: The Facts, 1989.*[48]

## Increased Efficiency?

The official Treasury statement on privatisation insists that the two main aims are the promotion of competition and increased efficiency.[49] However, Letwin states that the advocates of privatisation are not 'in a position (and have not generally claimed) that the mere act of privatisation

will guarantee increased operational efficiency'.[50] Other supporters of privatisation concur with Letwin. Veljanovski states that the claim that private property is a more efficient form of ownership than public property is 'vacuous'.[51] A case study of British Telecom's performance provides evidence for this view.[52] The *Financial Times* leader questioning the need to privatise the water industry also reflects some of these points, (25 November 1988). Private property can take many forms and such a simplistic claim is meaningless. According to Veljanovski, the debate on privatisation has confused three distinct issues – ownership, monopoly and national firms.[53] Given the forms which privatisation has generally taken in Britain, this hardly makes increased efficiency likely, in the term set by advocates of the programme. The lack of competition and the absence of the threat of a hostile take-over bid might, intuitively at least, suggest that the form that privatisation has taken would not be conducive to optimum levels of efficiency.

In reviewing the arguments, Kay and Thomson conclude that 'no simple generalisation about superiority of private sector performance can be sustained'. They further maintain that 'privatisation into an uncompetitive environment is likely to be positively harmful'.[54] They argue that liberalisation and competition are more important than nationalisation or privatisation in determining levels of efficiency. In response, Sam Brittan maintains that Kay and Thompson have 'given the Government a low grade, but in an examination which the Government is not actually taking'.[55] This returns us to the problem noted earlier, of identifying the objectives of privatisation. Another difficulty here is determining measures of efficiency. Increased profits would suggest that great successes have followed privatisation in some cases. British Aerospace doubled its profits in six years, Rolls-Royce almost trebled its profits, Jaguar turned a £44 million loss in 1980 to a £107 million profit in 1987.[56] However, restructuring of these industries occurred prior to privatisation – indeed with privatisation in mind – and external factors may have been more significant.

## Trade Union Scapegoats

A Conservative Party report drafted by Nicholas Ridley is referred to in a number of studies tracing the origins of privatisation.[57] The document has never been published and references are to a report of its contents in *The Economist* which made barely any mention of anything now understood as privatisation, except perhaps Heald's fourth element. Instead the emphasis was on the Conservatives' intention to demand that

nationalised industries achieve a set rate of return on capital employed and that investment would continue to be controlled by government through five-year rolling corporate plans. Far from advocating wholesale privatisation, the report of the document states that it would not be worth fighting a major political battle to oblige the nationalised industries to divest themselves of 'extra-mural activities' such as electricity and gas showrooms. The central theme of the Ridley report was apparently the means by which a Conservative Government could counter the threat of militant trade unionism.

The perception that trade unions were too strong, particularly after the 1974 miners' strike and the 'winter of discontent' of 1978/79, played a major part in the Conservative election victory. In line with economic theories of democracies developed by several authors [58] a critique of the role of the trade unions emerged which argued that they were a large part of the cause of Britain's economic decline. In nationalised industries, trade unions were viewed by the New Right as particularly damaging because of the 'absence of a real possibility of bankruptcy' which allowed for the 'postponement almost indefinitely' of the consequences of higher wage demands.[59] Mrs Thatcher's economic adviser maintained that the nationalised industries were 'used by powerful unions and other special interests for extortion and political purposes'.[60]

Privatisation was, however, not the major means of tackling public sector trade unions. Through three major Employment Acts passed in 1980, 1982 and 1984 the government reformed trade unions. This constituted the 'most obvious policy area where consultation and negotiation were not practised' [61], and involved:

i. a new set of individual employment rights in relation to non-union membership in a 'closed-shop';
ii. a narrowing of the boundaries of lawful strike action;
iii. a significant increase in the financial penalties to unions which stray beyond these new limits of lawful action;
iv. mandatory balloting of members of unions over a number of issues;
v. removal of some of long-standing props to support and supplement collective bargaining;
vi. a relaxation of individual employment rights in certain areas, particularly unfair dismissal rights.[62]

In this context, privatisation may have complemented the industrial relations strategy of the government but it was not central to it. There are interesting parallels between the Employment legislation and the privatisation programme – both were high profile and controversial programmes apparently breaking with a long-standing consensus, but both

might be better understood as responding to an emerging new consensus or tapping into popular concern.

## Changing Attitudes And Values

'Social engineering' is a term usually used pejoratively to refer to certain aims of left-wing governments. Indeed, this has been a major criticism of the left made by writers such as Hayek. Veljanovski refers to the 'anti-enterprise culture' which resulted from a combination of 'education, class and ideas' in Britain.[63] The notion of a 'dependency culture' which developed through increased public expenditure on welfare benefits and support for nationalised industries has not received the same academic attention in Britain as it has in the United States, where studies purporting to show the adverse consequences on the culture, attitudes and values of recipients and the wider society have been written.[64]

Privatisation is seen as creating an 'enterprise culture' through increased share ownership, encouraging liberal individualism and creating an environment in which latent entrepreneurial talents can be realised. Nigel Lawson has described increased share ownership as an 'incidental benefit'[65] whereas John Moore, in his 1985 speech, saw this aspect as more central to privatisation, creating a 'powerful lobby in favour of both efficiency and price restraint'.[66] But it is difficult to see the object of privatisation as primarily the creation of an enterprise culture. Nor can it be seen as motivated by a direct appeal to win votes. Apart from anything else, not all of the sales have been to the general public. Early examples of privatisation included the management buy-out of the National Freight Corporation in February 1982. The need to have 'loyalty bonuses' offering individual shareholders one free share for every ten held after three years suggests that the Government recognised that instead of encouraging the creation of a substantial shareholding public, privatisation simply offered many people the opportunity to make a quick one-off profit.

The rhetoric of privatisation is remarkably similar to that of socialist claims made for nationalisation. The populist element to privatisation is notable in a statement made by former Conservative Minister David Howell,

> 'she's taken up the theme of distribution of capital in a way that makes Tony Benn look like a moderate. Mrs Thatcher has embraced the theme and dream that we should have an irreversible widespread ownership of assets and capital in the nation and that this in a sense was the antidote to British Socialism'.[67]

The idea that ordinary people would be able to participate in decisions about these industries is as fanciful as the idea that Morrisonian nationalisation opened up opportunities for ordinary people to play a part in decision-making. The lack of accountability has, in fact, been a criticism levelled against privatisation.[68] Nevertheless, there has been a considerable increase in the proportion of the population owning shares since 1987. From around 6% the proportion has grown to over 20% in early 1988.[69] The privatisation of such large-scale operations as electricity and water supply may well result in Britain having a higher proportion of share-owners than in United States, where around 26% of population own shares.

## Electoral Considerations

Electoral considerations are important with most policies. The electoral costs of pursuing a policy may be worthwhile even if it is immediately unpopular, either if the Government believes its pursuit to be important enough or if longer term electoral benefits may follow. On the other hand, a policy may prove popular in the short term but have long term costs, including electoral costs. Privatisation, if viewed as part of the creation of an enterprise culture, can be seen as offering the prospect of long term electoral benefits. The 'death of socialism' is occasionally referred to by Conservative politicians and the suggestion is made that the privatisation programme is irreversible. The Labour party's policy of 'U-turns', abandoning its plans to renationalise, and its verbal gymnastics in articulating a popular version of nationalisation – preferring the euphemism 'social ownership' – are evidence of the Conservatives having the upperhand.

Explanations of voting behaviour always involve problems of causal interpretation. Purchase of shares in privatised industries may lead to support for the Conservative Party, but on the other hand support for the values which lead to support for the Conservatives might lead to the purchase of shares. On this the evidence is debateable. Although there is evidence that large scale defections to the Conservatives have not occurred through either council house sales or privatisation,[70] it may be that altering a political culture is a longer term process which will not be detectable immediately. Proponents of participatory democracy, for example, have maintained that the creation of a participatory democratic culture might take generations.[71] Alternatively, if not creating immediate converts, what might be achieved may be a consolidation of support.

The privatisation of housing provides the most obvious example of this. Presented as the creation of a 'property owning democracy', there were

over one million council house sales by September 1987, when a shift of emphasis was inaugurated to revive the private rented sector.[72] As in the case of the nationalised industries, the policy of sales had a number of objectives. As a former Labour MP and housing specialist has written, the Conservatives 'skilfully exploited the weakness in what has traditionally been the bedrock of Labour's housing policies – council housing. They have encouraged a million former tenants to buy their homes, and have played on tenants' dissatisfaction with badly designed, poorly managed estates and inefficient repairs services'.[73] Labour's evident discomfort and reversal of policy certainly suggest that council house sales have been a propaganda success for the Conservatives. While failing to have the revenue raising attractions of privatising nationalised industries, (but offering central government an additional weapon in its armoury in central – local relations), the Conservatives could present themselves as the supporters of individual responsibility and generally creating an enterprise culture.

## Who Gains?

Who gains from a policy probably tells more about it than anything else. However, this is not a simple question. According to the Government, the gainers are the personal share owners – increasing from three million to nine million over the last decade in Britain, the industries which are more efficient and market-oriented, and the country in general as the 'costs' to the Public Sector Borrowing Requirement of bailing out and subsidising these industries no longer remain. But, of course, this is a partial view. Certainly, many individuals have made windfall profits from privatisation. Far from being in the unpredictable market-place, purchasers in the share issues are a fairly protected species of investor. Through Government's continued overview and involvement – through regulation, 'golden shares', not to mention political interest – and through the low share price set by Government, those who bought shares almost invariably gained financially. However, as a study of the fixed price offers conducted after the stock market crash in October 1987 showed, there were greater gains to be made from stagging than holding onto shares over the long-term in many cases.[74]

It would, however, be extremely naive to imagine that the small shareholders have been the major beneficiaries. Wiltshire states that City interests have 'never had as much influence in No. 10 and No. 11 Downing Street as they have had under the Thatcher regime and privatisation is very much the evidence of this handiwork'.[75]

As suggested earlier, the City played six important roles in the privatisation process. A major problem in assessing the total costs to the Treasury has been Government failure to disclose details.

In terms of the total turnover, the costs of advertising might seem small. But in the context of advertising there can be little doubt about the magnitude of expenditure. The advertising has nothing to do with the sale of the goods produced but with the flotation. Robert Harris's remarks regarding the most expensive advertising campaign to be launched yet makes the point clearly,

> Anyone who had predicted 10 years ago that, by 1989, expenditure on water advertising would be running at a rate of £1 million per month would have been laughed out of court. Margaret Thatcher herself, committed to eliminating wasteful expenditure, would have had apoplexy. (*Sunday Times*, 30 April 1989)

The lost revenue to the Treasury of undervaluing shares in privatised industries is evident from the extent of over-subscription in most cases. Different methods of sales are available to the Government – public offer, trade sale or management/employee buy-out; using fixed-price tenders or some mixture of these; setting limits on the amount of shares available to individual buyers or foreign investors. None has proved fool-proof and staggering over-subscriptions have occurred. Amersham International was over-subscribed 24 times and British Airways 32 times over-subscribed.

Despite this, the Treasury has made massive gains, but these must be set against the fact that they may be only short-term gains. The Government argues that tax revenues from privatised concerns have been greater than previous receipts from *profitable* nationalised industries such as British Gas and British Telecom. The real test of whether the receipts from privatisation have been a benefit will only become evident in the long term.

## Thatcherism

What then explains the adoption of privatisation? Why did it become 'one of the most sustained and consistent single-minded pursuits of public policy in modern times'.[76] The answers lie in the notion of Thatcherism itself.

Both supporters and opponents of the Government find it convenient to project a particular image of the premiership of Margaret Thatcher. Neither front bench in the House of Commons wishes to present Mrs Thatcher as pragmatic. Breaking with the past, forging ahead with conviction and

confronting issues vigorously are part of the image portrayed – either as unrelenting dogmatism or conviction politics. The reality is somewhat different. Thatcherism is more an incoherent set of prejudices which borrows aspects of neo-liberalism as it suits than a principled set of policies. Its primary concern is to perpetuate Conservative rule. Other governments of different political persuasions have found no difficulty following the lead of Mrs Thatcher, because of the elements of pragmatism and expediency involved. The greatest victory of Thatcherism has been in setting the agenda of British politics, defining the rules of the game.

Pragmatism bounded by three constants seem the essence of contemporary Conservatism; Britain's decline, the need to get re-elected, and serving certain interests. Thatcherite objectives are complex, permitting any apparent change of emphasis at any given time to be incorporated in the Thatcherite myth. Thatcherism has been a general impression rather than a coherent ideology. The electoral appeal reflects this, as Crewe has noted:

> Cohesion, purpose and success take precedence over policy and ideology in voters' eyes; that is the lesson of Mrs Thatcher's and Thatcherism's astonishing success'.[77]

Certainly some fundamental aspects of the Thatcherite myth exist. The vague faith in the market and desire to roll back the state is the most important. Given the central place in the rhetoric of reversing the balance which had come to tilt in favour of the state and the general failure to achieve this, privatisation was, as Pliatzky has remarked, an 'enormous bonus'.[78] But as Gretton et al have shown, even this has not been achieved.[79] Overall, central government's writ remains largely as it was in 1979. Privatisation has clearly been a Godsend in maintaining the myth. Although there are aspects of short-term expediency involved, privatisation continues to be developed. The electricity supply industry and water authorities in England and Wales are to be privatised before the next election and speeches at the 1988 Conservative party conference by Ministers indicate that British Coal and British Rail are candidates for privatisation. The list is not exhausted. The self-generating momentum of the privatisation programme over the last decade suggests that areas which might be considered candidates only by fringe organisations such as the Adam Smith Institute may be privatised some time in the future.

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# 3 Canada's Privatisation Programme

**Janet Smith**

## Introduction

From Argentina to Zaire, virtually every country now has a privatisation programme. Certainly for Canada, Britain has been a leader whose example helped and encouraged us to get our programme underway. But in following the British lead, Canada by no means implemented a British-style programme. Canada's privatisation programme is a unique reflection of our country's economic, political and historical circumstances.

This chapter describes some of the links between Canada's distinct conditions and our approach to the issues of privatisation. In my opinion, national circumstances are the most important factors determining the privatisation course a country will follow. While we can and should learn from each other in the public policy area, I do not believe that we can lift a programme from one country and apply it to another.

## Canadian Conditions

What are some of those determining factors for Canada? First, there is Canada's enormous land mass. Canada is the largest country in the Western

hemisphere and the second largest in the world – more than 5,500 km east to west and more than 4,600 km. north to south. Its total area is almost 10 million sq.km. The United States has only about 9.5 million sq.km.

A second critical factor is population. Most of Canada is empty when it comes to people. The population of this vast area is only 25 million, a tenth that of the US, and only a slightly smaller fraction of the population of our major northern neighbour, the Soviet Union. There is a disparity between the size of our map and the size of our population. Historically this disparity has encouraged government intervention as a way of supplying vital national services – such as rail and air transport – that for a time the market would not supply. As a celebrated Canadian used to say, some peoples are victims of history: Canadians are victims of geography.

Canadians may be victimised geographically when it comes to human settlement, but Canadians are especially blessed by geography where natural resources are concerned. Today, manufacturing and services dominate our GNP. Historically, Canada was built on commodities, especially our rich forest and mineral resources. Shipments of these products take up most of our bulk transport facilities. And after automotive products, these commodities continue to dominate our exports, along with agriculture. To a very large extent, Canada's economy, although now highly diversified, is still in many ways resource-based. Because many of these resources are non-renewable, Canadians have looked to governments for assistance in managing them rather than relying only on markets.

Another factor explaining Canada's approach to privatisation is the role of foreign ownership. Encouraged by a national tariff policy, Canada's economic development gave rise to an industrial base dominated by so-called branch plants. Most of Canada's manufacturing and petroleum products sectors are still dominated by subsidiaries of companies headquartered outside Canada. This has caused Canadians to welcome foreign investment while looking to government to reduce any potential harm caused by high rates of foreign ownership.

Also, in our list of distinct Canadian influences, we have to say something about our constitution, especially its division of powers between federal and provincial governments. Canada's constitution gives the provinces control over their own natural resources, over their securities industry, over electrical utilities and, some argue, telecommunications. This affects the mix of public ownership by federal and provincial levels of government.

Among other uniquely Canadian factors, one should also mention our proximity to the United States. Canada is the only country in the world that shares an open border with such a huge, powerful neighbour, speaking a common language. In many ways Canada is lucky to be the mouse living next to the elephant. But we are a bilingual country with a parliamentary

system of government very different from the presidential system of the United States. Indeed the roots of our parliamentary democracy are found in the UK. Our proximity to the US calls, in the minds of many Canadians, for policies to ensure that the transmission of Canadian values is not 'crowded out' by the US.

A further set of factors affecting the uniqueness of Canadian policy is the character and condition of Canadians themselves: Canadians are highly educated compared to citizens of many other countries, and generally enjoy active participation in a free enterprise economy. Prosperity is generally speaking relatively evenly distributed. Most Canadians enjoy a high standard of living compared to other countries, even other industrial countries.

Canadians tend to own their own homes. Twenty-six per cent of Canadians own shares. We have no need to be in the business of 'people's (or popular) capitalism' as is Britain because we literally have it already. Despite our British heritage, we do not have a history of nationalisation and denationalisation over time.

These factors – a small population in a large national area, a resource-based economy, the predominance of branch plants, our confederal union with its complex division of powers between federal and provincial levels of government, our special relationship with the US, and the unique character of our people – are distinctly Canadian. They affect how we got into government ownership. And we have to take them into account when we get out of government ownership.

## Approach to Government Ownership

Like Britain, we have used government ownership to achieve certain public policy goals. But like the United States, we have also made extensive use of regulation of industry to ensure that its activities are consonant with public purpose. To be safe, we often used both.

The development of Crown corporations in Canada often reflects our unique history and geography: the need to give expression to coast-to-coast, Atlantic-to-Pacific nationhood. For example:

the Canadian Broadcasting Corporation – set up in 1932 to ensure a national broadcasting service when it looked like the private sector would focus only on major markets and not support a nation-wide service;

Air Canada – set up in 1937 to develop coast-to-coast air service because at that time the only way to fly from Toronto to Vancouver was through the US. While owning we also regulated the industry;

Canada Mortgage and Housing Corporation (CMHC) – formed in 1946 to make sure that veterans returning from World War II could find adequate and affordable housing, wherever they chose to live. CMHC in particular reflects the North American view that housing should be private, not public. It is one reason why we in Canada, unlike authorities in the UK, did not have a large stock of public housing to privatise over to the families living in them.

Taking this list together, it is not surprising, considering this history, that these and some other Crown corporations have acquired the status of national symbols. That status challenges anyone considering transferring them to private hands.

The federal government also used ownership to restructure or revitalise key industries. At the same time, we continued to regulate those industries. For example: The Canadian National Railway in 1919, the Cape Breton Development Corporation in 1967, Canadair in 1976, and Fishery Products International and National Sea Products in the early 1980s. Crown ownership was used to maintain jobs and activity in sectors considered of primary importance for national or regional economies. The purchases of Canadair and de Havilland are two such instances.

Speaking only of the federal level of government, there are currently 53 parent Crown corporations and 113 wholly-owned affiliates accounting for $58 billion in assets and about 169,000 employees (see Appendix I).

Provincial governments have also acquired and built companies. In fact, the corporate holdings of provincial governments exceed those of the federal government, both in assets and employees. A comprehensive survey carried out in the early 1980s identified some 233 provincial state enterprises.

Provincial holdings tend to be concentrated in the utilities. Eight out of ten provinces own their own electrical utilities, some of which are of significant size. Ontario Hydro, for example, is the third largest Crown corporation in Canada with gross assets of $32.7 billion and annual revenue of more than $5.3 billion. It employs 24,000 people. The three prairie provinces, Alberta, Saskatchewan and Manitoba, own their own telecommunications networks.

Provincially owned enterprises account for an important percentage of provincial gross domestic product. A 1977 survey placed the level at over 20 per cent in eight out of ten provinces. Three provincial governments, British Columbia, Quebec and Saskatchewan, have, however, put in place provincial privatisation programmes in the past couple of years. The province of Ontario has also undertaken a limited number of privatisations.

## Privatisation

So why now the interest in privatisation? A primary reason is Canada's post-World War II growth and development. In the last 20 years, the Canadian economy has matured. It is no longer as dependent as it once was on natural resources.

Canadian business is sometimes thought stodgy and stay-at-home. But a Canadian company is the largest commercial landlord in New York City, a Canadian company is the world's largest baker, the largest shoe manufacturer, the largest pulp and paper producer and the world's largest distiller. Perhaps more relevant to privatisation, Canada's domestic securities market is the fourth largest, after the US, Japan and London.

Given Canada's maturing economy, it makes sense to question the usefulness of continued Crown ownership in many cases. In cases where government ownership was justified on nation-building grounds, e.g. Air Canada, and where now there are private sector competitors, ownership is difficult to justify on public policy grounds.

Privatisation is also seen by some as a way of reducing the costs of government. This is true to the degree that privatisation helps reduce the size of government and transform potential cost centres into revenue sources. Privatisation in this sense is in line with, and helps reinforce, methods of expenditure control that have been developed at the federal level in Canada. As governments have become more concerned with the deficit, federal government managers have faced an increasing discipline on spending. For some years now, money for new programmes has come from reviews of existing programmes. In other words financing for new programmes came from cutting old programmes. Privatisation in this context can produce genuine win-win outcomes.

Improved systems of financial control led to a better (if sometimes startling) awareness of what some Crown companies were costing. Selling them is one way of reducing the number of such potential cost centres within government. In particular cases, transferring Crown companies to the private sector also removed some important constraints on their profitability. For example, attempts by Crowns to expand their lines of business to compete with the private sector resulted in complaints from potential competitors and a direction from the government for the Crown to drop the proposed new activity.

The sale of de Havilland to Boeing, for example, was one way of ending a potential multi-million dollar drain on federal funds. The sale also gave the company access to a worldwide marketing and distributing system that made its commercial survival, previously a question mark, into a short-term

certainty with considerable long-term promise.

As a footnote, there is a technical accounting reason why you cannot privatise your way out of a deficit in Canada. Privatisation does not always produce a benefit to the public purse, in terms of reducing the public deficit. Unlike some other countries, where state-owned enterprises have no value on the government's books, in Canada, the Crowns are carried at the cost of investment. So the impact of sale on the deficit depends on the difference between the sale price and the recorded value. That number can be positive, as in, for example, the Teleglobe sale. But often it will be neutral, or even negative. The benefits come not from the way assets are scored in one's bookkeeping. Rather, they arise from reducing the number of cost centres in government and adding to our tax-generating industrial base.

Let me now turn to an overview of how we are currently managing the privatising process.

The Canadian government's general approach to privatisation has been set out in several different times and places. To quote from the Agenda for Economic Renewal in November, 1984:

> There are several Crown companies which are predominantly, or in some cases entirely, commercial in character, and it is appropriate to consider whether continued public ownership is in the best interests of either the company or the country.

Then in the May, 1985 budget address, Finance Minister Michael Wilson stated:

> The government places a high priority on rationalising the current structure of Crown corporations. Crown corporations with commercial value but no ongoing public policy purpose will be sold.

These statements indicate the broad government approach; a case-by-case assessment of Crown companies to see whether government ownership any longer serves a public policy purpose. Governments have the powers to tax, to regulate, to spend or to own. In reviewing Crown ownership, the government is asking whether it would be better to perhaps sell some companies and, if there are still public purposes to be achieved, achieve them with regulation or other instruments.

One of the lessons we learned in the early stages of the privatisation programme was that we had to have a centralised process within the federal government. The development of a centralised process occurred in stages. Following the announcement of an intent to privatise in the May 1985 budget, the Prime Minister established a Cabinet task force with a secretariat at the

Treasury Board. This arrangement centralised decisions about selection of candidates for privatisation and, through the secretariat, coordinated policy implications. But it left the actual execution of sales within the line departments. Not only were there differences in the execution of the sales, but more importantly differences regarding timing of the sales. Further, no body of expertise was built up. Each department had to learn how to do it and then did not use the skills again.

Throughout the summer and fall of 1986, the management of the programme was centralised further. The government established a single portfolio responsible for privatisation and appointed the Honourable Barbara McDougall as Minister of State (Privatisation). Shortly after this a Cabinet committee with privatisation among its concerns was estabished under Mrs McDougall's chairmanship. At the end of 1986, the government established the Office of Privatisation and Regulatory Affairs (OPRA). The creation of OPRA set up a single organisation to control and implement all four elements of the privatising process: selecting the entity to be privatised, examining the public policy implications, recommending to Cabinet how to sell the entity and then actually selling it.

## Selection of Company to Sell

From the federal point of view we do not have utilities in our inventory. We have companies which would be considered high risk industrial or commodity stocks. For a government to sell shares, I would argue, it is easier and politically safer to sell utilities first. Witness the UK experience. Since we do not own utilities, the decision to privatise a large industrial company through a public share issue carries certain political risks.

When we review a Crown company for sale, the first questions we ask are: Does it still have a policy role? Is it commercially viable? Is privatisation feasible? Sometimes these questions involve unexpected complexity. Consider for instance the question of bilingualism. Our Crown corporations are required to comply with our Official Languages Act. In the private sector this may not be required. Other public policy issues are perhaps more straightforward, or at any rate more familiar. Competition policy: what if the acquisition by competitors actually reduces competition in the marketplace?

There are also foreign investment issues. For example, how much foreign participation should be permitted in the sale of our national oil and gas company? Despite the phasing out of the National Energy programme, foreigninvestment rules retain energy as a reviewable sector. Yet obviously the sale price will be higher if more bidders come to the auction. The fact that

these companies represent national symbols to Canadians makes it imperative that control remain in Canadian hands.

Some other trade-offs need to be weighed: suppose we have a public share offering and the share price starts falling. Clearly there is a political upside to selling public shares that make money. Clearly, too, there is a political downside to burdening the public with a lot of paper useful only to shortsellers. Hence the wise move on the part of the UK to sell utilities first.

Then there is the great question of 'Too Big to Fail': are these companies simply too big to let die? After all, such were the judgments that led to Crown ownership. So what is to stop new management from harvesting the hopes of the new privatisations and then leaving subsequent governments with another repair job?

These are just some of the questions our expert working groups must consider. These experts include people from the line departments, the company, and external legal and financial advisors all working under my office's direction. The reviews covering all the policy issues and the proposed method of sale are concluded with the preparation of recommendations to the Minister and Cabinet.

The third stage in the process is the preparation and execution of the sale, including tabling of divestiture legislation and the management of the bidding process or share issue.

Unlike the UK, the rules governing securities trading are a provincial responsibility. There are provincial securities commissions which operate much like the Securities and Exchange Commission in the U.S.. These bodies impose constraints as well on what can be done to promote a public share offering. They quake when they see the UK privatisation advertisements and are adamant that such behaviour will not be condoned in Canada.

## Conclusion

To sum up: the Canadian privatisation programme, like that of any country, should be viewed from the perspective of the country's unique circumstances – in Canada's case, how our history and geography have interacted to develop a particular mix of government holdings, special concerns about foreign ownership and distinct emotional associations of government ownership with national symbols and national pride.

Public administration in Canada has established a tradition of balancing private and public sector initiative to provide the best possible benefits to the Canadian public, as measured from within a Canadian context.

In the end, privatisation in Canada, as elsewhere, is an exercise in public sector management. The environment changes, the objectives change with it. So do the tools. But in Canada, as elsewhere, privatisation must take into account the unique circumstances of the country.

The federal government has set in place a structure and a process consistent with the Canadian reality. The model has profited from the British experience and the experience of others. But the model is a Canadian model. We have had to take our unique conditions and circumstances into account in creating Crown corporations, and we must make these same judgments when deciding to sell them. In the final analysis, we must succeed or fail by how well we meet the challenge of Canadian realities.

As of the end of 1988, a total of 18 privatisation initiatives worth some $1.57 billion had been completed. Four others are in process, the largest of which are the sale of the government's remaining interest in Air Canada and the sale of Cameco (see Appendix II). The process is well in place and is working. It has a credibility with Ministers and is seen by the private sector to be fair. Some of the sales have broken new ground. For example, the Air Canada sale, which was handled by the company and in which the company retained the proceeds, I believe was a first. We have had one of our privatised companies declare bankruptcy – Route Canada. While uncomfortable, I do not believe this has been detrimental to the programme. We have learned that as government, you have to get the policy straight first, that one should try to get clean deals (i.e. no continuing connections with the new owners), the process should be transparent and fair and as much information as possible should be provided to the public.

# APPENDIX I : PORTFOLIO OF PARENT CROWN CORPORATIONS

## Grouping by Activity

*Transport and Communications*

Canadian National Railway Company
Canada Ports Corporation
Local port corporations (Halifax, Montreal, Quebec, Prince Rupert, Saint John, St. John's, Vancouver)
Marine Atlantic Inc. (formerly CN Marine Inc.)
Pilotage Authorities (Atlantic, Great Lakes, Laurentian, Pacific)
St. Lawrence Seaway Authority
VIA Rail Canada Inc.

*Energy and Resources*

Atomic Energy of Canada Limited
Cape Breton Development Corporation
Petro-Canada

*Marketing*

Canadian Dairy Commission
Canadian Livestock Feed Board
Canadian Saltfish Corporation
Canadian Wheat Board
Freshwater Fish Marketing Corporation

*Industrial*

Canada Development Investment Corporation
Royal Canadian Mint
Enterprise Cape Breton Corporation

*Development and Construction*

Canada Harbour Place Corporation
Canada Lands Company Limited
Canada Museums Construction Corporation Inc.

Defence Construction (1951) Limited
Harbourfront Corporation
National Capital Commission

*Government Services*

Bank of Canada
Canada Post Corporation
Canadian Commercial Corporation
Canadian Patents and Development Limited
Standards Council of Canada

*Cultural Sector Corporations*

The Canada Council
Canadian Broadcasting Corporation
Canadian Film Development Corporation
National Arts Centre Corporation

*Financial Intermediaries*

Canada Deposit Insurance Corporation
Canada Mortgage and Housing Corporation
Export Development Corporation
Farm Credit Corporation
Federal Business Development Bank

*Other*

Canadian National (West Indies) Steamships Ltd
Mingan Associates Ltd.
Canadian Institute for International Peace and Security
International Centre for Ocean Development
International Development Research Centre
Teleglobe*

*(Has been sold but still exists as a legal entity)

## APPENDIX II : PRIVATISATIONS TO DATE

### Initiatives Completed

*Crown Corporations*

Northern Transportation Co. Ltd.
- sold July 15, 1985
- proceeds $27 million cash, plus repayment of $26.7 million in debt and accrued interest
- sold to a consortium of the Inuvialuit Development Corporation and the Nunasi Corporation

de Havilland Aircraft of Canada Ltd.
- sold January 31, 1986
- proceeds $90 million cash plus other considerations
- sold to The Boeing Company

Pecheries Canada Inc.
- sold April 18, 1986
- proceeds $5 million cash
- sold to La co-operative agro-alimentaire Purdel

Canadian Arsenals Ltd.
- sold May 9, 1986
- proceeds $92.2 million cash
- sold to The SNC Group

* CN Route (CN subsidiary)
- sold December 5, 1986
- proceeds $29 million cash
- sold to Route Canada Holdings Inc.

Canadair Ltd.
- sold December 23, 1986
- proceeds $120 million cash plus a $3 million dividend, $20 million in lieu of Challenger royalties, and other considerations
- sold to Bombardier Inc.

Northern Canada Power Commission (Yukon)
- sold March 31, 1987
- proceeds $19.5 million cash, a $16 million term note and a $40 million flexible term note
- sold to the Yukon Power Corporation

Teleglobe Canada
- sold April 3, 1987
- proceeds $488.3 million cash plus $16.6 million in preferred shares and retention of $106.6 million in cash and temporary investments
- sold to Memotec Data Inc.

* CN Hotels (CN subsidiary)
- sold March 31, 1988
- proceeds $260 million cash plus $5 million in working capital
- sold to Canadian Pacific Ltd.

Northern Canada Power Commission (Northwest Territories)
- sold May 5, 1988
- proceeds $53 million cash
- sold to the Government of the Northwest Territories

* Terra Nova Tel Inc. (CN subsidiary)
- sold December 1, 1988
- proceeds $170 million cash
- sold to Newfoundland Telephone Co. Ltd.

* Northwestel Inc. (CN subsidiary)
- sold December 1, 1988
- proceeds $200 million cash
- sold to Bell Canada Enterprises Inc.

* Air Canada
- sold October 13, 1988
- proceeds of sale of 45% interest (30.8 million shares): $234 million cash
- Treasury share issue

## Crown Holdings

Canada Development Corp. (47% interest)
- shares sold in three transactions between September 1985 and October 1987
- proceeds (1) 21.8 million shares: $246 million
  (2) 1.4 million shares: $15.8 million
  (3) 7.5 million shares: $99 million
- public share issue

Nanisivik Mines Ltd. (18% interest)
- sold October 28, 1986
- proceeds $6 million cash
- sold to Mineral Resources International Ltd.

Fishery Products International Ltd. (62.6% interest)
- sold April 15, 1987
- proceeds $104.4 million cash
- public share issue

Varity Warrants (8 million purchase warrants)
- sold December 31, 1987
- proceeds $3.2 million cash
- private placement

* CNCP Telecommunications and Telecommunications Terminal Systems (CN 50% interest)
- sold December 16, 1988
- proceeds $235 million cash
- sold to Canadian Pacific Ltd.

## Initiatives Underway :

Eldorado Nuclear Ltd.
- September 30, 1988 merged with Saskatchewan Mining Development Corporation to form CAMECO – A Canadian Mining & Energy Corporation
- privatisation to be completed within seven years

Air Canada
- sale of 55% interest (41 million shares) to be completed as soon as market conditions and the circumstances of Air Canada permit

Nordion International Inc.
- formerly Radiochemical Company, a division of AECL, now a subsidiary of the Canada Development Investment Corporation
- being readied for privatisation

Theratronics International Ltd.
- formerly Medical Products Division of ACCL, now a subsidiary of the Canada Development Investment Corporation
- being readied for privatisation

* Proceeds retained by corporation

## Summary

- 12 Crown corporations have been fully privatised
- 1 Crown corporation has been partially privatised
- Crown interests in 5 mixed ownership corporations have been divested
- 4 privatisation initiatives are underway

# PART II
# TELECOMMUNICATIONS

# 4 An Essentially Contestable Organisation: British Telecom and the Privatisation Debate

**Douglas Pitt**

## Introduction

The aim of this chapter is to provide a brief assessment and inventory of the attainments and problematics of privatisation as it has impacted on one key player in the United Kingdom telecommunications deregulation process, namely British Telecom (BT).

Specifically the question will be posed, has privatisation (and its stable mate liberalisation) resolved key managerial and political dilemmas omnipresent throughout the history of the state telephone industry in Britain? Linked to this is the question of whether, to the contrary, privatisation has introduced its own mare's-nest of emergent negative consequences. Just as the North Americans are taking stock of the deregulation experience in the USA (five years on from the formal resolution of the court case which led to the divestiture of AT&T), now is an equally opportune time to set out – as even-handedly as possible – the declared advantages and disadvantages of BT's privatisation. The year 1989 also marks the quinquennium of a British experiment of similar provenance to that in the United States.

It is taken here as axiomatic that the promise and problematic of BT's privatisation experience have both unique and wide significance. As one commentator has acknowledged, 'telecommunications represents the heartland of the state's control of industry'.[1] In a post-industrial 'information'

society, the construction of a viable and efficient telecommunications sector may be represented as being as significant in infrastructural terms as that key Victorian social and industrial project, the construction of the railways. As the present Government has conceded by its actions in this sector, it well recognises the relevance of telecommunications to its industrial (or post-industrial) policy ambitions. More widely, BT's organisational fate following privatisation may be tied to that of about-to-be privatised concerns. BT, as both its supporters and critics readily accept, is a 'paradigm' or test case of the wisdom or folly of disengaging key organisations from public sector control.

## A Tradition of Change

In a publicly expressed *cri de coeur*, the Chief Executive of BT unburdened himself of the opinion that 'the current period of change in the telecommunications sector in Britain (and elsewhere) has introduced the factor of turbulence and discontinuity into a monopolistic regime productive of artificialities – artificial relationships with equipment suppliers, artificially uniform service provision, artificial redistributive pricing structures...'.[2] This admonition and plea for novel organisational and managerial solutions to the perceived demands of a turbulent and complex technological, economic and political environment marks the latest effort to find a 'constitutional settlement' for BT which would endow it with the means whereby it could effectively establish a proactive organisational mission – one congruent with the exploitation of a fast developing family of products and services.

Such thinking as this finds its echo in the very earliest days of the telecommunications network. Victorian debates over the 'telephone question' frequently bore striking resemblance with those today.[3] Concerns were expressed about the monopoly position of the National Telephone Company (licensed by the Post Office) and its attempts to prevent open market entry. Competition and technological interconnectivity were also prominent in debate. Similar issues have re-emerged as central concerns in the 1980s with the rise to prominence of OFTEL and the Director General for Telecommunications.

Public ownership – effected in 1912 in response to the chaos and confusion resulting from thirty years of internecine company rivalry – placed the telecommunications system under direct Post Office administration and unitary control. Ironically, it was an outcome supported both by large business users (a key influence in the move to deregulation in later decades) and a broad church of parliamentary opinion including Tory MPs. At this time, the Post Office appeared as a better guardian of the spirit of entrepreneurialism than the erstwhile privately owned telephone companies.[4]

Unfortunately, the succeeding decades were to deal a blow to this idealised picture of a state trading agency. By the 1920s many of those happy to at least tolerate the adoption of a *dirigiste* solution had become strident in its condemnation. The Department was shackled by a Treasury motivated by financial stringency and determined that the Post Office should not stimulate telephone penetration by 'acting in advance of demand'. Bureaucrats – 'amateurs' – were moreover in charge of a service (telecommunications) demanding high levels of technical expertise. Lofty disregard for its clientele was also much in evidence. A Select Committee in 1920 damningly declaimed that 'the public was made for the Post Office, and not the Post Office for the public'.[5] Notable 'insiders' such as C.R. Atlee, a Labour Postmaster General, and a Tory counterpart, Lord Wolmer, an Assistant PMG, promoted the idea that the Post Office was not a conventional 'supply' department but rather a commercial organisation. As such it required a high degree of independence from detailed Treasury control and a more flexible ('organic') structure – particularly on the telecommunications side.[6]

Such arguments resurfaced in the findings of the influential Bridgeman Committee in the 1930s. It, too, argued for greater financial freedom for the Post Office, coupled with a plea for the establishment of a more flexible organisational format for telecommunications. Furthermore, control of a highly technical service like telecommunications should not be in the hands of 'lay' bureaucrats; 'engineering considerations were not properly taken into account' in the deliberations of the Post Office Secretariat.

To a considerable extent, further historical developments in Post Office (latterly BT) telecommunications reveal a debate with the ghost of Bridgeman. During succeeding decades, the question of how best to administer the telephone function was never far from the surface. Change, however, has been continually compromised in the event. Bridgeman's reforms were to prove short-lived. The potential of the 1930s was quickly dissipated by the Second World War. The Treasury reasserted strong financial control, while the strategic importance of telecommunications confined it to the close centralising embrace of Cabinet control. Such in turn, prejudiced imaginitive schemes of internal reorganisation.

Even with the return to power in the early fifties of Conservative administrations intent on denationalisation, the Post Office remained (for reasons of strategic importance) within the ambit of the central department system. In fact, Tory rule was accompanied by a strongly reactive managerial style within the Department which was captured in the notorious remark of Reginald Bevins (a Tory Postmaster General) that 'I should be a bigger fool than some people take me for if I attempted to provide a telephone in every home'. Such complacency was underpinned by a Treasury captivated by a monetarist credo and determined to deny the Post Office sufficient long-term

capital funding. In consequence, the Department wallowed under an image of 'do-nothingism' presiding over levels of telephone penetration behind the US and the continent. While the Bell logo in the States still summoned a vision of commercial efficiency, the Post Office was further forced into the role of 'everybody's Aunt Sally'. Its management was that of a spoiled identity.

In keeping with the managerialist tenor of the times – government departments and the civil service were to be subjected to unprecedented criticism for their failure to effectively manage the British economy – the 1960s opened with the passage of an important piece of legislation, the 1961 Post Office Act. Radical in intent, it hoped that this would free the Post Office from detailed Treasury oversight. Incoming Labour Prime Minister Harold Wilson was quick to appoint to the office of Postmaster General Anthony Wedgewood Benn, arguably one of the most important internal change agents in the Department in the post-war period. Determined to carry the managerialist message of the 1960s across the portals of the organisation, Benn was quick to point out that any freedom conferred by the 1961 Act was being dissipated through the entrenched quietism of Post Office civil servants. It was merely being used to 'get away from government, get away from the unions and get away from the customers'.[7] Such bureaucratic 'retreatism' demanded a robust response. This Benn provided through the pursuit of internal reforms aimed to establish clearer lines of authority in both posts and telecommunications while seeking change in the formal status of the Post Office from orthodox government department to quasi-independent agency along the lines of the post-war nationalised industries. The ultimate achievement of corporation status in 1969 [8] in theory conferred greater independence from government control (through an 'arm's length' relationship). Such would allow the organisation to be able to respond better to the pressures of increasing environmental dynamism – particularly evident in technological change. However, the 1970s would once again reveal disappointment in the implementation of such noble ideals. It was to be a decade punctuated once again with continuing complaints about Treasury interference together with a breakdown in the relationships between successive chairmen and sponsoring ministers.

## Historical Discontinuity

The accession to power of a Conservative administration in 1979 can be interpreted variously as constituting both a logical outcome to a lengthy process of historical development or as a major departure from the classic historical departmental debate. Certainly, the rhetoric of 'Thatcherism', the ingredients of which variously included: controls on public spending, attacks on inflation, a reduction in the economic activity of the state and the

encouragement of greater competition [9], has been portrayed as providing the necessary and sufficient conditions for a period of 'regulatory discontinuity' in the affairs of the Post Office.

Two factors weighed heavily with Sir Keith Joseph, the incoming Secretary of State for Industry. First, he recognised the importance of the argument that 'a genuine revolution (had) begun in the advanced industrialised countries...the long heralded convergence of computing and telecommunications (had) really started to happen'.[10] Secondly, he recognised the saliency of the case put by large business users to the Carter and Howlett Committees [11] that 'telecommunications had become a limiting factor in the installation and effective utilisation of computer systems...(there was an emergent) major users' need for maximally cost efficient integration of telematics technology'.[12] He quickly decided to go further than the 'caution and controlled liberalisation in the supply of certain subscribers apparatus' proposed by Carter. Such contrasted with the attitudes of the previous Labour administration. The irony of a Conservative government embarking on such a radical course was not lost on one commentator who wailed... 'the Post Office nettle has had to be grasped by a reactionary government with no concern for public enterprise. That, however, is the penalty for the Labour government's irresolution and timidity'.[13]

The period 1980-84 was of axiomatic importance to the organisation. Subtended by two enabling acts, it witnessed the rise to prominence of, successively, 'liberalisation' and 'privatisation'. Under the first, freedom was to be given to private organisations to supply and install all types of attachments, subject to independent technical approval, and there would be freedom to provide, over BT circuits, services which offered storage and processing facilities not provided or planned by BT. A new telecommunications authority (BT) would at last be granted independent status with posts separated into a separate agency.

Several factors appear to have impelled a transition from 'liberalisation' to 'privatisation' – the latter eventually consummated after the Tory election victory in 1983. During the early eighties the Government and corporation were once more at loggerheads over the proper means for ensuring that the organisation would be able to finance its capital spending programme. Experiments with the so-called 'Buzby Bond', an attempt to inject a measure of private sector capital into the organisation, met with Treasury resistance. A hastily contrived White Paper suggested that such a funding solution 'would leave BT subject to government interference and control'.[14] To allow the organisation greater freedom would involve transferring BT's business to a Companies Act company and selling a majority of shares in it to the public. Such would allow it to borrow outside the Public Sector Borrowing Requirement. True to the spirit of the Carter Committee that BT

should be subject to 'controlled liberalisation', the 1980 Act nevertheless began to show its inadequacies. In particular, there was widespread recognition that BT was still judge and jury over too many issues. Internal and external critics complained that, acting as its own approvals body for equipment, it was able to attenuate the process by which competitors could connect their equipment to the BT network.

The extended policy process between 1980 and 1984 had several interesting features. First, it was improvisatory. The omission of important aspects of a regulatory regime (OFTEL did not make its appearance until the second Act), contrived to present a picture of ministers making policy 'on the trot'.[15] Secondly, it marked the transition of important union groups (key members of the former 'corporatist' policy community) from 'insider' to 'outsider' status.[16] The so-called 'Campaign Against Privatisation' launched by the British Telecom Unions' Committee (comprising six of the main trade unions within BT) while arguably effective in the grass-roots sense, can be alternatively interpreted as evidence of the frustration of those unions with settled processes of negotiation within the policy community. By mid 1982, Sir George Jefferson, BT's chairman, was busily telegraphing his intention to change the basis of the negotiating framework within BT. He declared that liberalisation must be seen as demanding different patterns of consultation within the organisation; those existing could no longer proceed at the pace that 'had been appropriate in monopoly conditions'.[17] Thirdly, it revealed the astuteness of BT's strategic coalition. Exploiting the dependency relationship between DTI and BT (the latter was the source of key information and advice), Jefferson was effectively able to set the agenda of change and secure post-privatisation conditions favourable to BT. Aided by Minister of State Kenneth Baker's zeal for information technology, (Jefferson consistently alluded to BT's position as the 'battleship of the British BT fleet'), he asserted the virtue of an 'administered trade' solution. BT, 'merely' the size of one of the US Regional Bell Operating Companies, could only effectively compete in foreign markets from a home base with retained integrity. He successfully managed the transition to privatised status in such a way as to avoid the breakup of BT in a thorough-going divestiture of its constituent parts. BT, as a major player in the telecommunications game, was thus able to effect the move to privatised status through the medium of a managed transition.

## The Organisational 'Right Stuff' – the 'Ramping Up' of BT

Liberalisation and privatisation are invariably presented as introducing an important element of discontinuity into the affairs of BT and increasing the degree of environmental turbulence and uncertainty to which it is subject.

A list of important environmental changes and challenges facing BT in the 1980s would include the introduction of competition in VANS; the issue of a licence for an alternative network (Mercury), the establishment of a new regulatory body (OFTEL) with impressive formal powers including the 'satisfaction of all reasonable demands for telecommunications services, the promotion of the interests of consumers, users and purchasers of telecommunications equipment with regard to price, quality and choice, and the promotion of competition at home and overseas'. The extent of these changes was symbolised by the abolition of BT's exclusive privilege.

The articulate major premises of Conservative liberalisation/privatisation philosophy can be expressed in managerial terms as an attempt to shift the organisation (BT) from a reactive to a proactive stance towards its environment. Market entry would force the adoption of important cultural, structural and strategic changes. The aim throughout was the construction of an 'adaptive corporation'.[18] It is hard to avoid the conclusion that BT's efforts at internal organisational change aimed at giving it a 'crackerjack' image have closely paralleled the experience of AT&T which has, since divestiture, experienced what one commentator has described as a 'cultural train wreck'.[19] According to this analysis, AT&T has been 'ramped up'; it has engaged on a structural renaissance featuring a change from an organisation based on functional principles to one based on a 'line of business' approach. Research, manufacturing, marketing and sales units have been re-brigaded under one of five marketing orientated divisions. A former AT&T executive has pointed to the most difficult and important task that the organisation has had to face attaining a goal of 'psychological divestiture'.[20] Bell's 'care taking' image had to be relinquished in favour of a more 'risk taking' approach. According to one of the chroniclers of organisational change in a divested AT&T, 'the company's first educational task is to move hundreds of thousands of human beings into what is, for many of them, an entirely new culture...'.[21]

In July 1984, on the eve of full privatisation, one management consultancy organisation succinctly set out privatisation's putative advantages

> the efforts of the Government and BT have combined to produce a financial management and operating structure consistent with the required characteristics of a commercial organisation with which to present potential investors. The influence of Sir George Jefferson has been extremely significant in achieving this transformation, in particular through the creation of a working environment in which members of staff can identify with key business objectives. This will be stimulated by profit centre orientation which will fundamentally change the performance of management and staff at all levels, and the resulting improvement in

> management responsibility and motivation will foster the development of a greater awareness of consumer needs. The resulting management flexibility and responsiveness will be vital given the expansion of the product range of equipment and services necessary in developing markets, and to stimulate demand in mature markets. The achievement of this will enable BT to regard the new liberalised environment positively as an opportunity for expansion rather than negatively as a competitive threat.[22]

Understanding of the imperative implicit in environmental transformation was not lost on BT's strategic coalition. Key decisions makers were sensitive, in advance of privatisation, to the need to anticipate the consequences of a turbulent environment and prepare the organisation (and government) to face their exigencies. Jefferson, by wide consent, played an influential educative role with Ministers, alerting them that BT required a controlled transition. He also reminded other important elements of the telecommunications policy community that key industry relationships would be increasingly subjected to searching review. Addressing members of the Telecommunications Manufacturing Association (TEMA) at their annual dinner in 1983 he ventured to suggest (with undoubted cynicism) that 'the new regime should allow your members the opportunity of unleashing their mysteriously hidden reserves of resources directly to customers'. Henceforth, suppliers would have to convince BT that they 'can provide internationally competitive products'.

If notice was served on the suppliers that venerable relationships with BT might be subject to review, no less sacrosanct were the 'corporatist' relationships with the unions. As already mentioned, Sir George was increasingly intent on changing the industrial relations climate within which the organisation had previously operated. BT managers, he insisted, were caught in the grip of a 'consultation inertia'. The centralist orthodoxy of industrial relations had hitherto neutered management and given them the impression that 'they were responding to the rules of the organisation rather than the marketplace'.

From the premise that practices pertaining to a monopsony/monopoly situation with captive suppliers and customers had no relevance to the emerging telecommunications marketplace, Jefferson constructed a change scenario involving radical organisational restructuring – specifically the re-brigading of the organisation along a line of business approach. This attempt at grouping personnel so as to relate their activities and objectives directly to individual market segments, directly parallels changes which have occurred in AT&T in the US following the divestiture of the company. Such structural change was to be embedded within a new cultural paradigm. This latter was

seen as being arguably the most important and fundamental aspect of the post-privatisation revolution. It would also be accompanied by significant processual changes.

## Cultural Transformation

The imperative of cultural change was given prominence in speech after speech by 'change champions' within the organisation. Such was aimed at a transformation of the dominant behavioural mores, value system and the 'spirit' of the organisation. Paralleling the American apothegm, 'Ma Bell doesn't live here anymore', BT was intent on conveying the message to staff and outside environment alike that 'bureaucracy is no longer in residence'. According to this *Weltanschauung*, the values which had sustained a public service ethic were uniquely unfitted to the realities of a market environment. They were the 'wrong stuff' for that stage in its life cycle currently being experienced by BT. The 'right stuff' for values suited to a more threatening and challenging environment were their opposite. Quality enhancement was one necessary ingredient, productivity improvement was another. Risk taking should supersede mistake avoidance as a key organisational requirement. 'Administrative' mores – enshrined in Jefferson's oft quoted view of Post Office officials that they had the self image of the district commissioner rather than that of the modern entrepreneur – should be relinquished in favour of a more competitive 'management' ethos. As with AT&T, previous stress on the value of seniority should be replaced by that of performance.

Much of this was implicit in a celebrated (or notorious) address (known as the 'Coventry speech') delivered by Iain Vallance, then Managing Director, Local Communications Services, in 1985. Announcing his intention to turn BT LCS into a 'Top Telco' by the end of the eighties, Vallance insisted that BT would possess the 'best internal telecommunications business in terms of the aptness and *quality* (my emphasis) of its services and products, its efficiency and value for money available anywhere in the world'.[23] Following this peroration, district managers were constantly reminded of the imperative need to 'search for excellence'. The achievement of such a goal, clearly derived from the ideas of Peters and Waterman and other US management writers, depended on the encouragement of the 'initiative, enterprise and imagination of individuals'.[24] Following the government campaign in 1985 for a quality drive in British industry, quality improvement became a cardinal operational goal of the organisation. This would drive up the standards of BT's products and services and imbue a new sense of purpose and pride.

Breakdown of the bureaucratic value system and its replacement with a set of more proactive cultural values has been trumpeted by BT management since 1984. An increasing number of managers throughout the organisation are on personal contracts and are judged according to performance. Line management has been strengthened in comparison to its 'staff' equivalent. Risk taking is encouraged and rewarded through a payment by results reward strategy.[25]

## Structural Change

Since the late 1970s, management has consistently deployed the argument that the lessons of Bridgeman (*sic*) had not been learned – the basic problems identified by that Committee five decades earlier were still very much in evidence. There was a duality of control within the organisation between 'engineering' and 'administrative' grades and functions, a separation of financial control from line management and the absence as a consequence of real measures of decentralisation allowing the adoption of a 'close to the customer' approach.

By 1979, problems with the existing functional organisation were apparent. Accordingly, important structural changes were put in train in BT, changes which included reorganisation of its main board. In anticipation of liberalisation, the functional form of organisation (separate departments responsible for *inter alia*, R&D planning, finance etc.) was partially relinquished. Its weaknesses were its denial to management of the ability to carry out tasks in a coordinated manner and the resolution of inter-divisional conflicts at too high a level in the organisation. At this time, there was increasing recognition of the growing threats (and opportunities) of liberalisation – it would impose the discipline of the marketplace.

Recognising the need to proceed incrementally – the organisation lacked the accounting resources needed for the establishment of full business style profit and loss accounts necessary for the full implementation of a 'profit centre' concept – the strategic coalition nevertheless moved quickly to put into effect important change measures. The appointment of Sir George Jefferson as chairman and chief executive produced a rapid transition to a profit centre approach. This was established in 1981 together with the re-bridging of the functional organisation into a divisional form. Inland Division henceforth took over the old Post Office telecommunications structure. Arranged into a single entity divided geographically into regions and areas, this was further divided in 1982 into National Network Services and Local Communications Services. British Telecom International (BTI), providing international and maritime communications services for the UK, reflected BT's leading role in world telecommunications. British Telecom Enterprises were set up to

manage four businesses previously run by the regional chain of command which ran the basic telephone service: Consumer Products, Merlin (Business Products and Systems), Information Systems and Spectrum. This division recognised the increasing importance of the large business customer and the saliency of value added network services (VANS). Major Systems would be responsible for fulfilling the corporate function of providing the other (operating) divisions with their equipment needs. Like them it worked on the principle of profit centres. Changes consequent on liberalisation and privatisation were well reflected within this division. Procurement policy has changed against the background of an increasingly turbulent environment. It also reflected a changing relationship with suppliers who now have to be internationally price competitive. Further changes in the divisionalised structure have occurred in tune with changing circumstances. In 1988, for example, a new Communications System Division was established as part of an effort to position the company 'as a major worldwide communications and information technology player'.

The professed 'bottom line' philosophy resident behind these changes is that of 'getting close to the customer'. Centralisation in the organisation was held to have been productive of important goal displacement – with their gaze diverted upward to the top of the organisation, management had taken its eye off the customer; it had allowed an organisational retreat from the marketplace. Such mission misdirection was particular evident in LCS. In 1983, Iain Vallance insisted that greater devolution was essential if the organisation was to respond quickly to its customers '(we must) pass the power and responsibility for taking decisions as close to the people actually dealing with the customers as we possibly can. We must also replace the old functional structures at area level with something that will enable us effectively to face up to competitive markets'.[26] Area reorganisation was brought about in 1983 with the professed aim of establishing a 'local' organisation well equipped to deal with varying market demands and able to establish more effective accounting practices. It was quickly followed by an important districtisation. This was crucially linked to thinking on the development of a 'customer service system' – the development of a 'front office' structure in which sales orders, service enquiries and billing matters could be settled at a single point in the organisation.

## Processual Change

Structural changes have been accompanied by important 'processual' changes. The devolution of power and responsibility to the district level was, for example, premised on the need to improve methods of measuring

organisational performance. In 1984, McKinsey's were commissioned to 'assess the requirements for managerial control in the embryonic LCS districts and to specify a commercial management control process to support district workings'.[27] The consultants were quick to point out that existing control systems had reinforced a process of 'management by procedure'. In the new organisational environment following in the wake of privatisation, management control should be concerned with manager motivation and the adoption of key measures to show managers where to direct their energies, targets to define what they are committed to achieving, rules to guide their decision making, authority to enable them to make choices in their own patches and rewards for 'excellence'. In a world of cascading acronyms, the latest in a long line of attempts to encapsulate a performance philosophy has taken the shape of 'ARMOR': Achieving Results Through Management and Operational Reform. Described as a programme of work aimed at strengthening management control and improving operations, the key elements of the ARMOR programme are: the clarification of the task objectives of each manager; devising performance measures which are specific to his tasks and which tell him whether he is succeeding or failing; ensuring that across activities, divisions and business, performance measures are coherent and consistent, and the establishment of effective reporting arrangements on performance. Key control measures should be 'few in number, simple to understand and able to measure overall performance against particular objectives'.

## Strategic Discontinuity

A SWOT analysis ('strengths, weaknesses, opportunities and threats') of BT strategy would quickly reveal major challenges in the kinetic environment which it currently faces. In particular, the entry of new players to the 'telecommunications game' has reduced (as was intended) BT's freedom of unilateral action and produced a situation of increasing strategic uncertainty.

No better measure of the seriousness with which BT management takes its changing environment exists than that of its more aggressive marketing style and policy. By the late 1970s (i.e. well before privatisation) there was a well developed awareness in the organisation of the imperative need to place marketing at its leading edge. The appointment of a former managing director of ITT Business Systems (UK), John King, and Director for Marketing and Corporate Strategy (in 1984) was an earnest of BT's intent to attack the domestic and foreign marketplace with increased fervour.

Evidence of the visibility and ascendancy of marketing within the organisation since privatisation takes various forms. The sheer professionalism of its flotation (an unprecedented act) reveals a largely

successful attempt to market itself and change its image from a staid public utility type organisation to that of a modern 'information technology' company. The much vaunted 'power behind the button' campaign was creatively executed.[28]

Illustrative of the galvanising effect of competition on BT has been the establishment of a 'Directors' Programme' (1984) in response to charges of marketing 'amateurism'. This was set up with three objectives in view: to establish the extent to which company directors should be involved in information technology and communications decisions and identify the advantages which can accrue; to enable directors to appreciate the benefits which the new technologies offer for the development of business opportunities; and to emphasise the human and organisational implications of the continuing development of the new technologies.

Image management – changing the conventional perception of BT from a public utility to that of a leading edge high tech information company – is also evident in such attempts as that of its Central Territory organisation to launch a 'third wave' marketing and advertising campaign at the large business market niche.[29]

The importance of the 'close to the customer' approach implicit in the ascendancy of marketing and commercialism is revealed not only in the changing pattern of relationships binding the organisation to its external environment. Its impact on the internal decision making process is also marked, particularly in strategic planning. Until 1980 the dominant planning orthodoxy was for long term planning horizons. The impact of liberalisation/privatisation has marked a change in the intellectual basis upon which the planning exercise is constructed. Planning must now be seen to reflect a concept of 'strategy' based on a rapid response capability to take account of market opportunities as and when they arise. Just as competition reduces equipment depreciation cycles, so too, it diminishes time depreciation cycles.

Changing elite conceptions of the marketplace and the appropriate response to it is implicit in BT's 'move offshore'. BT has sought to replenish its diminished home market share with a strong attack on overseas equipment and services sectors. BT, criticised for being 'introspectively UK fixated' before privatisation, has sharpened its international image in the period succeeding it. It has resorted to joint ventures ('Joves') as a means of gaining market entry abroad in 'months rather than years'. Such have included agreements with Malayan companies to expand and modernise Malaya's telecommunications infrastructure and the establishment of new companies (e.g. the inauguration of a new company BT&D Technologies in association with Dupont to manufacture and market optelectronic components). Also in evidence has been an aggressive acquisition policy, a noted example of which was the

takeover of the Canadian company Mitel, a manufacturer of small and medium switches. In 1988, BT announced its acquisition of a 22 per cent holding in McCaw Communications, a company with a commanding presence in the American cellular sector. BT is currently (1989) engaged in applying for a licence to enter the lucrative cable TV market in Hong Kong.

Such policy is evidence of BT's determination to become a significant international player. The attempt to attain the status of an international information technology company was central to Jefferson's efforts to protect BT through the agency of a managed transition from public utility to a public limited company (plc). He cannily foresaw the dangers to this strategy inherent in any attempt to 'balkanise' BT by divesting it into a series of smaller companies. Jefferson's recognition that a privatised BT must become less dependent on the vagaries of the domestic economy and apply itself vigorously to a policy of global repositioning has been paralleled in the announced intention of his successor Iain Vallance to concentrate on overseas market sectors that seem to promise long term growth potential.

## Only Disconnect? The Dialectics of Disengagement

It is tautologically true to suggest that BT is different by virtue of liberalisation and privatisation. What seems reasonably clear, however, is that the changes which have occurred or are in train are widely perceived – positively or negatively – as representing a substantive period of discontinuity in the life cycle of the organisation.

The objectives of privatisation were succinctly stated by Cecil Parkinson, the Secretary of State for Industry, to Parliament in 1984. They were to

> develop the UK telecommunications industry as quickly as possible to the widest possible benefit to UK customers and manufacturers...to extend share ownership and to create within the new shareholding constituency a category of shareholder employees with a vested interest in the strength and vitality of BT's business...reward achievement through the mechanism of incentives so that reward would be intimately related to performance (and) to provide BT with a source of investment finance largely free from Treasury control.

The following are typical of the organisational effects claimed to emanate from the liberalisation/privatisation phase. First, management style is changing with the appointment of managers at the commanding heights who are acting as the carriers or 'champions' of an entrepreneurial risk-taking culture at variance with its predecessor the Post Office – bureaucratic and risk averse. Secondly, marketing style is becoming more aggressive with 'new

look' sales promotions, advertising and the recognition of discrete marketing niches requiring service from 'dedicated' account managers. Thirdly, the organisation has become more 'results orientated'. Devolution and decentralisation have been accompanied by improvements in management information systems. The quality of information provided for effective management in a fast changing, competitive and commercial environment has improved. The use of techniques such as ARMOR has been specifically designed to reduce operating margins through a reduction in overheads. The introduction of profit centres has done much to make staff aware of 'profit' as a *sine qua non* of organisation viability in an open market situation.

Freed from the financial bureaucratic constraints implicit in its earlier status as a government department, BT has responded with unaccustomed agility to the competitive environmental threats implicit in liberalisation/privatisation. Nothing has been more instructive of the seriousness and speed with which BT has reacted to changing market trends than the establishment of Mercury and the arrival of switched network competition from early 1986. The threat of Mercury (menacingly targetted on precisely the most lucrative part of BT's network business – the large metropolitan business user) has, in the view of many commentators, galvanised BT's strategic coalition in ways which have taken them (the commentators) largely unawares.[30] 'Management by surprise' has also been a feature of the post-divestiture stage in US telematics. Here some of the newly liberated BOCs (Bell Operating Companies) have shaken predictions that they would remain rather staid public utility type companies. Instead they have conveyed an image of aggressive, 'no-holds-barred' *information companies*.

Unsurprisingly, perhaps, such a roseate picture of organisational vitality and achievement does little to dispel the increasing perception of BT as an organisation only laggingly responsive to the exigencies of a changing technological and commercial environment. For BT as with its predecessor the Post Office, 'the critics are always with us'.

Protests from within BT over a deteriorating organisational climate have punctuated the post-privatisation phase. The adoption of a 'commercial paradigm' [31] by BT management has been widely viewed by key members of the internal union constituency as productive of tensions within the previously settled industrial relations climate. Management has been perceived as moving from a 'representative' orthodoxy of conflict resolution to a highly 'punitive' alternative. The latter was exemplified in the immediate post-privatisation charge by management (vigorously denied by the unions) that union members were engaged in makework practices or so-called 'Spanish customs'. The breakout from corporatism evident in the legislative phase, *supra*, began the development of a situation of 'low trust relations'. On this view, constantly reiterated managerial pleas for 'working together to ensure success', are to a large extent cosmetic and must be viewed against its

penchant for unilateral 'executive action'. Reminiscent of the earlier agenda item of the 1960s, 'managerial prerogative', this has resonated badly with the unions.

The stridency and rancour which the unions have argued is characteristic of the industrial relations climate is perceived by them as having spillover consequences for the wider community served by BT. The ascendancy of commercialism has displaced key 'bureaucratic' values – dedication to the service ethic, equity as between business and domestic users, involvement of staff representatives in the formative stages of policy. The unions have claimed that phone costs to the ordinary consumer have risen as BT has rebalanced its tariffs in favour of the business user, BT's 'buy British' policy has been abandoned to the detriment of indigenous suppliers, standards of service have been lowered and safety and general conditions of employment for BT staff have worsened. No less significantly, 'short termism' is exemplified in the reduction which has occurred in in-house R&D.[32] Again, such 'downside' effects of change have been noted in the US where union voices have been added to a chorus of complaint that deregulation and the divestiture of AT&T have worsened the balance of trade, undermined research capability and been productive of job losses.

Consideration of the external environment within which BT operates inevitably raises the issue of the effectiveness of the new regulatory regime. The establishment of OFTEL and the appointment of the Director General of Telecommunications (DGT) is a direct reflection of the government's announced intention in 1982/3 to avoid the establishment of a large regulatory body mirrored on US lines. Along with the rejection of 'rate of return' regulation, with its tendency to inflate the asset base of the regulated company, the rejection of an FCC type solution to the regulatory problem was based on a fear that it would lead to litigation and bureaucracy. Rather than accept the 'prospective' formula as in the US whereby tariff increases are subjected to scrutiny in advance of application, the British solution was to opt instead for a compact Office of Telecommunications which would rely mainly on retrospective intervention. Hopefully this would provide an agile, non-bureaucratic regulatory structure positioned to respond quickly to changing environmental and technological conditions.

The issue of compactness, *inter alia*, contributed to early fears that OFTEL would prove ineffective against an organisation with the size and power of BT. Given the pragmatic and 'sensibilist' approach of the present DGT, OFTEL has fast constructed for itself an image of fairness and pro-competitiveness. (Admittedly criticisms that it is a watchdog with rubber teeth still surface intermittently). A major new player in the 'telecommunications regulation game', OFTEL has taken an 'activist' interpretation of its role. This has been revealed in a series of 'significant

events' since its establishment. In the 'interconnect' dispute between BT and Mercury at the beginning of 1985 the DGT was able to act in a useful conciliatory capacity following a legal judgement that 'heads of agreement' between BT and Mercury were null and void. His 'any to any' principle effectively guaranteed consumers use of the Mercury network 'end to end' with BT. Other significant early moves included advice rendered to the Secretary of State against the establishment of a proposed joint venture with IBM. He also intervened in the acquisition of Mitel, reflecting the fears of indigenous equipment suppliers that the proposed BT/Mitel deal would confirm BT's unfair advantage in the domestic PABX market. He was pressured, too, to intervene on the issue of BT's announced intention to 'second source' some of its major switch supplies (buying 'system Y' digital exchanges from Thorn-Ericsson to ginger up Plessey and GEC in their supply of the system X counterpart). BT's ability to bypass the recommendation of the DGT that system Y should be phased in over a three year period (to allow GEC and Plessey time to accommodate to newly competitive circumstances) revealed signs of contradictory public policy signals. As the Mitel case clearly emphasised, the DGT's urge to promote competition ran up against the 'industrial policy' drive of the DTI to allow the acquisition to proceed in support of regional development goals.

The Mitel and Thorn Ericsson cases have been taken as lending support to those critical of the post-1984 regulatory system in Britain. Lacking strong formal regulatory powers over BT, OFTEL has nevertheless been able to exercise considerable influence over its regulatee. The DGT's frequently expressed concern with the quality of service offered by BT led to its resumption in 1988 of the publication of quality of service indicators on a regular basis. OFTEL has scored a similar success on the pricing front. In late 1987 the DGT announced that he was considering the possibility of triggering a Monopolies and Merger Commission inquiry into BT's pricing formula.[33] This threat undoubtedly contributed to a tightening of the 'RPI-3' agreement in existence since 1984 (whereby price increases on a 'basket' of BT services were kept 3 per cent below the retail price index). In mid-1988, a more draconian 4.5 per cent limit was adopted.

The DGT's activities are, of course, intimately linked to prevailing views of BT. For example, surveys by Age Concern and the National Consumer Council have been cited by OFTEL as contributing to its anxieties over quality of service issues.[34] BT plumbed the depths of public opprobrium in 1987, its most recent *annus miserabilis*. The troubles occasioned by a damaging industrial relations dispute at the beginning of the year fuelled a crescendo of public criticism. A malodorous critical genie was out of the bottle. Not only had privatisation failed to improve service delivery by BT, it was widely perceived as leading to its deterioration. The journalist Paul Johnson (once on the political left, by then a convert to Thatcherism) caught the distemper of

the times well. He declared 'BT seems set fair to make itself the most loathed institution in the country within a year or so, a by-word for inefficiency, overmanning, high charges, complacency and indifference'.[35]

Thus to the predictable criticism of the left [36] that privatisation would lead to 'cream skimming' by BT's competitors, deterioration of service quality and loss of employment, had been added the *trahision des clercs* of the right. 1987 was to witness the spectacle of leading Tories claiming that BT was handling its new freedom maladroitly. The consequence of this was that it was generating wide dissatisfaction which might ultimately prejudice the success of future privatisation experiments. Cecil Parkinson's scenarios for the privatisation of electricity were certainly influenced by the BT 'fiasco'.[37] Accompanying this generalised criticism of BT came an attack on the organisation for its conservative response to the problems of succession occasioned by the resignation of its chairman Sir George Jefferson. In opting for an insider (Iain Vallance) as chairman, BT was widely perceived as losing the opportunity to exploit the entrepreneurial talents of an industrial change agent. By that token it had effectively revealed itself as possessed of old and bad bureaucratic habits.[38]

One thing which these contemporary criticisms has made plain is that BT can escape its past only with difficulty. 'Liberalisation' and 'privatisation' are not, if the example of BT is typical, instant panaceas for the British disease. As such, BT is a useful reminder to the government that the connection between policy formulation and policy implementation may be strewn with difficulties. The devil may be in the details.

Certainly, the change agenda of BT is an unfinished one. But, the acrimonious tenor of recent debates over BT has done little to acknowledge the progress which the organisation has undoubtedly made in the years since the formal act of privatisation (a period of intense internal activity). Neither has it done much to illumine some of the very real issues and dilemmas which will continue to surround the organisation. Crude *argumentum ad hominem* attacks, like the one which has been directed at the 'uncharismatic' Iain Vallance serve to obscure his important contribution to a major cultural overhaul in BT. Vallance's mercurial rise to chairman at the comparatively youthful age of 44 speaks volumes both for his general management ability and understanding of the challenges posed by technological and environmental change. It also hints at the capacity of the organisation to encourage 'intrapreneurialism' (*sic*).

Vallance has expressed the view that BT management has only a limited time to 'manage its spoiled identity' and improve its performance or run the risk of witnessing pressure build up for a much harsher regulatory regime. At the top of his agenda is the continuing need to achieve higher levels of staff motivation.[39] As the most recent Annual Report makes clear, BT continues

to turn in financially respectable results.[40] Turnover and operating profit – (respectively £10,185m and £2,609m) showed growth of 9.1 per cent and 11.1 per cent. Capital investment, reflecting BT's commitment to continued improvements (such as digitalisation) of the network currently stands at over £2,300m. Complacency, however, is ruled out. Out-turn figures for the last quarter of 1988 reveal a slight slowing of BT's growth perhaps reflective of Mercury's aggressiveness in the business user market. 1992 also casts its shadow forwards. BT clearly only has a limited time to 'ramp up' to take full advantage of an open European telecommunications marketplace. Liberated European PTTs will constitute a formidable competitive challenge. BT's acceptance of the possibility of a sale of part or all of GEC/Plessey telecommunications business to Siemens of West Germany at the beginning of 1989 is evidence of its prescient recognition of the pressures for European market reconfiguration.

The process of shaping BT's policy future has already begun. As has been shown, BT's price formula has already been reviewed and tightened. The DGT has further indicated the clear possibility that existing prohibitions on the resale of private circuits will be lifted adding further to competitive pressures on BT.[41] 1990 marks the review of the 'synthetic network duopoly' of BT and Mercury. While the encouragement of new network providers seems unlikely (costs of market entry are formidable), a DTI study group report has argued forcibly that 'BT's dominance remains a factor requiring careful consideration...the regulatory regime will need to ensure that BT is not allowed to add to its existing market dominance or to establish pre-emptive positions in new market areas which develop'.[42] Safeguards might include allowing cable companies to offer voice telephony and act as 'common carriers' in their own right.

The developing debate within and outside BT, the DTI and OFTEL on the future direction of British telecommunications policy must attend to some critical issues. In the view of some critics a key element of the *cui bono?* question remains unattended. When will the residential consumer directly benefit from the new (privatised) regime and the new technologies with lower prices and enhanced services?.[43] The social issue of the 'information rich versus information poor' is one which is reverberating around the US policy community. Will further network competition rebound only to the benefit of the large and powerful or will its benefits be allowed to filter down to the 'information "dispossessed"'? The integrity of BT itself will perhaps again jostle for inclusion on the change agenda. 'De-merger' – an option rejected in the 'rush to deregulate' of the 1980s – is unlikely to abdicate as an issue of the 1990s. 'Big is beautiful' may be renounced in favour of 'small is imperative' as the boundaries of telecommunications are further eroded through technological advance. However, the conflicting pressure to retain the existing shape of BT in pursuit of its role as a viable 'policy player' in the

international telecommunications arena are similarly unlikely to diminish. The future shape of the relationship between government and BT may also be revisited. Ironically, the issue of accountability may be sponsored by the same political groups at the forefront of the push to privatisation. Already some Tories are insisting that the government should delay selling off its remaining interest in BT the better to exert pressure for innovation on its strategic coalition. In view of the determined efforts which have been made for decades to escape close ministerial control, this last has a certain piquancy.

A rush to judgement on the 'success' or 'failure' of the BT experiment is surely unwise. The jury should stay out for a further period of deliberation. Difficulties in escaping the legacy of its past – underinvestment, bureaucatic procedures etc. – must be fully taken into account in such an assessment. What is already evident however is that, in comparison with the relative ease of flotation, 'now comes the hard part'. BT, as Vallance has been quick to acknowledge, must rededicate itself to customer service. In an increasingly uncertain world one thing is sure – the politics of 'getting from here to there', of moving the organisation into congruence with the demands and aspirations of the interests with which it is forced to come to terms, will be as contestable a matter as in its past. In this sense, privatisation does not reduce criticism but, to paraphrase Clausewitz, continues it by other means.

## Notes

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# 5 Deregulation and Privatisation in the Canadian Telecommunications Sector: The Case of Teleglobe Canada

**Charles M. Dalfen**

## Introduction

Unlike the case in other countries, such as Japan and the United Kingdom, that have witnessed the privatisation of major telecommunications companies, in Canada the privatisation of Teleglobe Canada, the designated overseas telecommunications carrier, took place largely outside the context of the telecommunications policy process. Whereas in both Japan and the United Kingdom the privatisation of Nippon Telephone and Telegraph and British Telecom respectively were part and parcel of a move towards greater telecommunications competition, in Canada the privatisation of Teleglobe Canada proceeded along quite a separate track. It represented neither the overt effect, cause or complement of greater liberalisation or competition in the telecommunications sector, nor of any other Canadian telecommunications policy change. This important difference between Canada and the other two countries has had a number of significant effects.

One was that the Teleglobe privatisation process required a three phase bidding process, and eighteen months to complete, during which time there was often considerable confusion as to the Government's objectives, and even at times as to who the responsible Minister was. Secondly, the final price was affected, in that different policy decisions could have resulted in different prices for the acquisition. Thirdly, the privatisation did have an impact on the

telecommunications policy process, but in a way that was not necessarily foreseen – or perhaps even desired. And fourthly, the lack of a clear relationship between the telecommunications and privatisation processes appeared to undermine the Government's rationale for the privatisation of Teleglobe, as well as its intentions with regard to other federally-owned telecommunication companies.

This chapter discusses the structure of the Canadian telecommunications sector, including its operating, regulatory and policy components. It reviews the current state of competition or liberalisation in the telecommunications sector. It discusses the Teleglobe privatisation process, particularly in regard to the principal telecommunications issues that it gave rise to. And it discusses the Government's rationale for privatising Teleglobe. The chapter concludes with a discussion of some of the lessons of the privatisation process from the telecommunications viewpoint.

## The Canadian Telecommunications Sector

Telecommunications services in Canada are provided by a number of telephone companies, most of them owned by private shareholders. The largest of these is Bell Canada which serves the greater part of Canada's two most populous provinces, Ontario and Quebec. Bell accounts for nearly 60 per cent of the Canadian telecommunications industry's revenues. The second largest firm is the British Columbia Telephone Company (B.C. Tel), serving the province of British Columbia. Bell and B.C. Tel are privately owned. The provinces of Alberta, Saskatchewan, and Manitoba are served by provincially-owned Crown corporations called Alberta-Government Telephones (AGT), Saskatchewan Telecommunications (Sask Tel) and Manitoba Telephone Systems (MTS). The Atlantic provinces are each served by a telephone company owned in part by Bell Canada. There are, in addition, some 65 smaller telephone companies in the various parts of Canada, most serving only one or two municipalities. Canada's nine major telephone companies have created Telecom Canada to corordinate trans-Canada traffic and to provide for settlement of revenues arising from certain classes of interprovincial and international traffic. The Canadian domestic satellite carrier, Telesat Canada, is the tenth member of this group. Telesat is a corporation half owned by the telecommunications carriers and half owned by the federal government.

CNCP Telecommunications, a partnership of the publicly owned CP Ltd. and the Crown-owned Canadian National Railways, is the telephone companies' principal competitor across the country in a number of specialized telecommunications markets and in regard to private line (as distinct from public telephone) services. Cellular telephone service was introduced in

Canada in 1985 and is provided by local telephone companies directly or (in the case of Bell and B.C. Tel) by corporate affiliates and by Cantel Inc., the nationally licenced cellular telephone company.

Canadian traffic to the U.S. is provided by agreement between Telecom Canada (and CNCP for other than public telephones) with U.S. carriers such as AT&T, MCI Telecommunications and GTE Sprint. Overseas traffic is provided by agreement between the domestic carriers and Teleglobe, which in turn enters into agreements with overseas carriers.

As far as regulation is concerned, Canadian telecommunications regulatory agencies parallel the operating companies. At the federal level, the regulatory agency is the Canadian Radio-television and Telecommunications Commission (CRTC), an independent quasi-judicial tribunal. Bell Canada, B.C. Tel., Telesate and CNCP Telecommunications are within its jurisdiction, and together they account for about 3/4 of the revenues of the Canadian telecommunications sector. At the provincial level there are independent regulatory agencies in each province except Saskatschewan.

In addition to regulators, the federal and provincial governments also have ministries responsible for telecommunications within their juridiction. These ministries have been playing an increasingly large policy role, particularly in areas related to competition in telecommunications services.

## The State of Competition and Deregulation in the Canadian Telecommunications Sector

As a result in part of the patchwork of carriers, regulators and ministries across Canada, (although for other reasons as well), both the degree of competition in the Canadian telecommunications sector and the areas that have been removed from regulatory scrutiny are relatively limited, as compared with the United States, Japan and the United Kingdom. It is also the case that the rules in each sub-sector vary considerably, depending on whether a company is subject to federal or provincial jurisdiction, and depending on which province or provinces it operates in.

For purposes of the present discussion it is perhaps sufficient to say that unlike the U.S. and Japan, where there is a policy of open competition in the provision of domestic and overseas long distance telephone services, and in the United Kingdom where two companies are licenced to provide these services, in Canada domestic long distance telephone service remains the monopoly of Telecom Canada, and overseas service that of Teleglobe Canada.

As regards cellular telephone service, as in the United States, this is provided both by 'wireline' (i.e. telephone company) and 'non-wireline' carriers on a competitive basis. There is also competition in Canada in

'private line' long distance services and in the provision of terminal or customer – premises equipment.

As far as deregulation is concerned, there has been a growing movement towards the deregulation of telecommunications services that are offered competitively, including the rates for customer premises equipment and cellular telephone service. In addition, the CRTC has now decided to deregulate the telecommunications services of CNCP Telecommunications that are provided on a competitive basis, on the grounds that CNCP is not the 'dominant carrier' and, unlike the telephone companies, has no monopoly base to serve as a source of cross-subsidy for its competitive services. [1]

## Teleglobe Canada

Teleglobe Canada was incorporated by the Parliament of Canada in 1949 as the Canadian Overseas Telecommunications Corporation, [2] with the powers to acquire ownership of the Canadian portion of the submarine cable facilities of Cable and Wireless Ltd., then a U.K. public corporation, and the shortwave radio facilities of Canadian Marconi Ltd., a subsidiary of the Marconi Company in the United Kingdom.

The creation of the corporation followed closely on the heels of the 1945 Commonwealth Telecommunications Conference, for whose members the trauma of World War II was still very much alive. Public ownership of the overseas telecommunications facilities that were necessary to link the Commonwealth countries appears to have been regarded as essential to their national and collective security and was indeed recommended in the Conference's final directive. All Commonwealth countries, including Canada, proceeded to enact the necessary legislation. [3]

While the Parliamentary debates at the time do not shed much light on the matter, it does appear that security concerns were predominant in calling for both Canadianization and state ownership of Canada's overseas telecommunications facilities. [4]

Teleglobe's mandate was set forth in section 6 of the enabling statute. The corporation was to:

- establish, maintain and operate in Canada and elsewhere external telecommunication services for the conduct of public communications;

- carry on the business of public communications by cable, radiotelegraph, radiotelephone, or any other means of telecommunications between Canada and any other place;

- make use of all developments in cable and radio transmission or reception for external telecommunication purposes as related to public communication services;

- conduct investigations and researches with the object of improving the efficiency of telecommunication services generally; and

- coordinate Canada's external telecommunication services with the telecommunication services of other nations. [5]

While this mandate did not specifically confer a monopoly on Teleglobe, it has effectively been translated into a de facto monopoly over the provision of Canadian overseas telecommunication services.

By agreement with the domestic carriers, overseas public telephone traffic is sent and received at three 'gateways' (Montreal, Vancouver and Toronto), and is carried within Canada by the domestic carriers. Overseas rates are set by Teleglobe, but the domestic carriers, which are effectively its only customers, retain roughly half of the Canadian portion of the revenues from overseas calls, which is in turn approximately half of the total revenues from the calls, the other half going to the overseas carriers.

Teleglobe's revenues, which are well over $200 million annually, amount to some 9 per cent of the Canadian long distance market and slightly less than 3 per cent of the total Canadian telecommunications market. Its annual profits average some $50 million, on an asset base just before privatisation of some $300 million. Teleglobe had 1300 employees in 1986. [6]

Teleglobe co-owns (or has ownership rights in) a variety of trans-Atlantic and trans-Pacific submarine cables, as well as in the satellite facilities of the International Telecommunication Satellite Organisation (Intelsat) and the International Maritime Satellite Organisation (Inmarsat).

## Telecommunications Policy Issues and the Privatisation of Teleglobe Canada

On August 1, 1985, after some months of public discussion and after receiving certain preliminary offers, the Government announced that it was 'proceeding immediatley with the privatisation of Teleglobe Canada' by calling for 'final proposals' from prospective purchasers.

Accompanying the announcement of the Government's intentions was a set of 'Policy Assumptions and Guidelines', (the August '85 guidelines), which would form 'the general direction for government policy with respect to Teleglobe'.

While the Minister of Communications stated that 'the privatization of Teleglobe will not require, or cause, any fundamental changes in telecommunications policy', it became clear that at least three questions had to be dealt with in order that bidders could know precisely what it was they were bidding on. One related to the de facto monopoly status of Teleglobe. A second to the restrictions, through regulation or otherwise, that might be placed on Teleglobe's earnings. And a third to the question of the role of the domestic carriers in the ownership of Teleglobe.

Under the pre-existing arrangements, Teleglobe had had an effective monolpoly, both in regard to Canadian overseas facilities and to traffic. Thus it was the only Canadian entity that was authorised by the Government to land submarine cables in Canada and to own earth stations interfacing with international satellites, guaranteeing that all overseas traffic directly to and from Canada would be carried on Teleglobe facilities. The Government indicated that this 'single interface policy' would be maintained, but it was only willing to commit itself for a period of five years.

The other – and more important – respect in which Teleglobe's monopoly was insured was by the undertakings of the domestic carriers to route their overseas traffic directly through Teleglobe, under inter-carrier agreements whereby Teleglobe set the end rates to customers and the parties shared the Canadian portion of the overseas revenues based on a specific formula. However, the Government was silent on the question of whether it would ensure that those undertakings would be continued. This gave some bidders considerable concern, given that the domestic carriers effectively constituted Teleglobe's sole source of Canada-overseas traffic.

As regards the second issue, Teleglobe had previously not been subject to rate regulation. While it was expected to return part of its net income to the government each year, this was decided annually as part of Teleglobe's budget approval process, and the company had not been regulated either as to its prices or its earnings. With privatisation, however, it became clear that Teleglobe would have to come under some form of regulation, particularly for as long as it held an effective monopoly position. In the August '85 guidelines the Government indicated that the regulator would be the CRTC.

What it did not indicate, however, was the precise basis on which Teleglobe would be regulated. It stated only that 'some form of regulation on prices, profits and/or rates of return will likely be instituted under the authority of the CRTC' and indeed invited bidders to make offers both on the basis of 'traditional rate base/rate of return' regulation and of 'price regulation not tied to return on equity'.

As regards the third issue, viz. carrier ownership involvement in Teleglobe, there was a concern that while on the one hand, without some such ownership the carriers might be inclined to by-pass Teleglobe, on the other hand, with such ownership the independence of Teleglobe might be compromised.

The August '85 guidelines provided no guidance on this question.

When bids were filed, on October 18, 1985, bidders generally filed two, three or more alternative bids, based on the different possible ways that the Government might ultimately decide to answer the major policy questions. There followed a long period of thirteen months of no response from the Government.

Eventually, on November 19, 1986, the Government wrote to all bidders, having clarified a number of the telecommunications policy issues. On the issue of the Teleglobe monopoly, the government reiterated the five year 'single interface policy' on cables and satellites. While it refused to enshrine the existing relationships with the common carriers in legislation, it was prepared to stated that 'existing regulatory powers, specifically those regarding the approval of connnecting agreements between carriers, supplemented by governmental policy direction as required, will be employed to ensure that established international service arrangements and practices are maintained and the Canadian telecommunications traffic is routed on Canadian facilities to the maximum possible extent'. [7] As regards regulation, the Government stated that this would be on the basis of rate of return on an approved rate base.

Finally, as regards carrier ownership, it set an eventual limit on their participation in Teleglobe at the level of 1/3 ownership, and allowed them an initial participation of up to 40 per cent, at a price that would be as low as or lower than the price paid by the successful non-carrier bidder. It also added a requirement that at least 15 per cent of the shares must be sold to the public, including some 5 per cent to Teleglobe employees, within three years.

Following further correspondence on the monopoly issue, in which the Minister of Communications eventually stated that 'the government has made its public commitment to secure an orderly established relationship between Canadian, domestic and overseas carriers abundantly clear.....', [8] six bids were finally submitted on January 9, 1987.

On February 11, 1987 the Minister of State for Privatization announced that a letter of intent had been signed to sell Teleglobe to Memotec Data Incorporated of Montreal, the high bidder at $488 million.

## The Government's Rationale for Privatising Teleglobe Canada

The most concise summary of the Government's reasons for privatising Crown-owned companies in general appears in a document issued on May 1, 1987, by the Ministry of State for Privatization and entitled '*Excerpts from Statements Made by the Honourable Barbara McDougall on the Reasons for Pivatization*'.[9] While not referring specifically to Teleglobe, the document

lists the following five reasons why the federal Government considers that privatisation is appropriate in general.

1. A changing economic environment could cause the original objectives of a Crown corporation to vanish; or alternatively, taxation, spending and/or regulation can be more valid options to ownership.

2. The efficiency of a Crown corporation could be improved by being placed within the test of the marketplace.

3. The great demand that public ownership places upon government resources to properly manage and support these undertakings on a day-to-day basis.

4. The inability of Crown corporations to properly adjust to changes in markets and/or technologies due to the slow and deliberate decision-making which is inherent in the operation of a business using the taxpayers' money.

5. The inappropriateness of Crown corporations competing head-to-head with one or more entities in the private sector.

While some of these reasons may have been considered by the Government to be applicable in the case of Teleglobe, none was specifically cited. Nor does their applicability appear to hold up on closer examination.

Thus, not even the staunchest advocate of Teleglobe's privatisation could argue that Teleglobe has been a burden upon government resources, either in terms of management or support. To the contrary, Teleglobe had been a consistent money earner for the Federal Government. [10]

Nor was the privatisation of Teleglobe necessary to eliminate a Crown corporation that was in any way directly competing with the private sector. Indeed Teleglobe has enjoyed an effective monopoly on Canadian overseas telecommunications services since its creation.

As far as the changing economic environment is concerned, while there have certainly been changes in both the domestic and international economic environment over the last 40 years, it is not clear how these have caused Teleglobe's original objectives to vanish.

A related reason, provided in a Fact Sheet issued by the Department of Communications in late 1986 to prospective bidders for Teleglobe, was expressed as follows:

'The Government of Canada is proceeding to privatise Teleglobe Canada because Crown ownership, which was appropriate under the circumstances

when the company was created in 1949, is no longer essential to achievement of its primary mission. The privatisation is consistent with the overall direction of Canada's telecommunications policy.' [11]

Although neither the original circumstances nor the 'primary mission' are specifically elaborated, the references appear to be to security rather than to economic considerations. And while this might on first glance appear to be the basic reason for privatisation, on further consideration it appears to be more in the nature of why a potential objection to privatisation may no longer be valid.

As regards the question of consistency with 'the overall direction of Canadian telecommunications policy', it is of course far from clear what this refers to, either in terms of policy or ownership, particularly given the wide variety of ownership arrangements that exist among the different telecommunications companies in Canada. Moreover, as discussed earlier, the privatisation process appeared to have been more independent of telecommunications policy than consistent with it.

As far as increasing Teleglobe's efficiency under the test of the marketplace is concerned, this would appear to be belied by the fact that Teleglobe will retain its monopoly status for at least five years. While it will be regulated by the CRTC, regulation is a highly imperfect substitute for competitive market conditions, particularly where a company is regulated on the basis of its rate of return on assets and has every incentive to increase it assets rather than its efficiency.

Finally, in regard to Teleglobe's ability to properly adjust to changes in markets and/or technologies, the Minister of State for Privatization herself acknowledged during the Parliamentary debates that Teleglobe was well managed and profitable. [12] While she commented also that it was restricted in its ability to seek out profitable new business ventures, [13 ] no evidence was offered as to any opportunities that had been missed.

In addition to the reasons cited by Minister McDougall, other reasons have been offered from a variety of sources. One suggestion during the Parliamentary debates was that the privatisation was carried out because it had 'popular appeal'. In support of this point one Member of Parliament referred to a 'national poll', in which 60 per cent of people surveyed wanted the government to divest Crown Corporations.[14] There is, however, no evidence that the public at large had any knowledge or interest in the privatisation of Teleglobe or that the Government gained – or could have gained – any major political benefit from it.

It has also been suggested that the reason for Teleglobe's privatisation was that the Crown corporation was not accountable to any regulatory body and that its tariffs were at unacceptably high rates. In the parliamentary debates the Minister of Communications emphasised that with privatisation,

Teleglobe's rates would be reduced by 13.5 per cent, and that since Canada's overseas telephone traffic was more of a 'family' than of a 'business' nature, rate reduction would have a more profound beneficial effect on the every-day Canadian. [15] What this argument ignores, however, is the fact that the Government could have directed Teleglobe as a Crown corporation to reduce its rates, and that the rate reduction in question was indeed planned by Teleglobe management well before and independently of privatisation. [16] Teleglobe could also have been made subject to CRTC regulation as a Crown corporation. [17]

The 'world trend' towards privatisation was also referred to as a justification for the privatisation of Teleglobe. During the Parliamentary debates in particular, the Government emphasised that countries as diverse as China, Spain and the United Kingdom were turning to privatisation to alleviate economic woes. [18] However, this appears less as a reason for the privatisation of Teleglobe Canada than as an argument in support of the decision. The references to China (and to a lesser extent to Spain) were directed particularly at criticism from more leftist House critics.

Two reasons remain, one perhaps stranger than the other, but both with some support as to the underlying rationale for the privatisation of Teleglobe. The 'strange but true' reason is that the proceeds of the sale would go into the consolidated revenue fund and thereby help reduce the federal budget deficit. [19] This rationale is supported by the fact that the Government expressly insisted that the transaction close by March 31, 1987, the final day of the Government's fiscal year.[20] What is strange about the reason is that the overall proceeds from a one time sale of Teleglobe are not only small in relation to the federal deficit, currently estimated at some $29 billion, but that Teleglobe would be far more useful to the Government as an ongoing source of revenue. Nevertheless, some $500 million in a pre-election year may well have appeared far more interesting than $50-100 million in annual taxes and profits over the longer term.

Ultimately, however, probably the most important reason lies in the Government's ideological position that business activities should, wherever they are viable, be left to the private sector, with the Government's role limited to that of regulator. As one Government MP put it, while '....Teleglobe is a vital and viable company, Crown ownership is no longer considered necessary for the achievement of public policy purposes. The best possible terms have been found, private ownership combined with public regulations will provide significant benefit to all Canadians'. [21] And as one Minister put it, the sale of Teleglobe meant '...giving back to the private sector its rightful place'. [22]

Essential to the rationale, of course, is the matter of viability. Without viability the private sector is unlikely to want to enter a line of business, and is therefore unlikely to generate funds to make offers to the Government. It is

important, therefore, having decided to move ahead on privatisation as a matter of policy, that the Government then select particular Crown corporations whose viability appear to be secure. Among these, Teleglobe was clearly – as one opposition MP put it – the 'Crown jewel'. [23]

What is clear, however, from these efforts to discern a rationale is that, notwithstanding a reference in a Government fact sheet a year and a half into the process, that the privatisation was 'consistent with the overall direction of Canada's telecommunications policy', that it was essentially carried out within a separate context from telecommunications policy, almost forming more of an obstacle than a rationale for the process.

## The Consequences of Separate Contexts

It is probably not unfair to say that the privatisation process was complicated, prolonged, and made considerably more expensive both to bidders and to the Government by the Government not deciding on certain key telecommunications policy questions until over a year after the preliminary bids and the first set of 'final' bids were submitted.

It is also not unfair to say that certain telecommunications policy decisions could have realised a higher price for the Government than the amount actually paid for Teleglobe. This would, for example, have occurred if the decision had been taken to enshrine the Teleglobe monopoly for a longer period and on stronger terms than those which the Government was prepared to countenance. It would also have occurred if a form of price regulation had been selected similar, for example, to that which British Telecom is subject in the UK rather than a base/rate of return model such as that applied to Bell Canada. (It would also have occurred had the Government not placed a 20 per cent ceiling on foreign ownership. Indeed a number of foreign bidders were said to have filed preliminary bids for considerably higher amounts than that ultimately realised.) It should of course be added that lower prices would have been achieved had the decision been taken to open Canadian overseas telecommunications traffic to competition.

To some this may indicate a careful balancing of privatisation and telecommunications policy elements in order to achieve a reasonably high (although perhaps not the highest) price without completely (although certainly partially) enshrining a monopoly. On balance, however, it would appear that, in contrast to other countries where, as a result of privatisation, a more deregulated environment has been established, in Canada the result of the privatisation of Teleglobe is an extension of monopoly and an increase in regulation. At one level this results simply from the fact that whereas previously Teleglobe Canada was unregulated, it is now a company regulated

as to its rate of return by the CRTC. At another level, however, the Cabinet has added powers to the CRTC that were not there before in order to ensure that the commitments that were agreed to by the successful bidders are effectively implemented. [24] Moreover, whereas other countries, such as the United States and the United Kingdom, are in the process of reducing regulatory constraints on their major carriers, and of accepting price regulation rather than that based on rate of return on equity, in Canada the existing regulatory model has been reinforced.

This has meant that the manner in which Teleglobe was privatised may have undermined one of the central potential benefits – and part of the essential rationale – of privatisation, as experienced in countries such as Japan and the United Kingdom, viz. contributing to liberalisation in the telecommunications sector, with its attendant benefits in terms of customer choice, business efficiency and economic growth.

Finally, the policy separation leaves us with little guidance as to whether or not other Crown corporations in the telecommunications sector may be privatised, such as the telephone company subsidiaries of Canadian National Railways (Terra Nova Tel in Newfoundland and North WesTel in the Yukon), or whether or not the Government's fifty percent shareholdings in Telesat Canada and CNCP Telecommunications will be sold to the private sector. [25]

The Canadian telecommunications company that is currently considered to be the strongest candidate for privatisation is Alberta Government Telephones, the provincial Crown corporation that operates the telephone system in Alberta. Again, however, this would appear to be a privatisation more for ideological than telecommunications policy reasons. Indeed combination of privatisation and the continuance of monopoly in Alberta would underline one of the major reasons why the Teleglobe privatisation proceeded as it did. And that is that the current federal Government attaches great importance to factoring the views of provincial governments into the telecommunications policy-making process. These governments by and large – and most notably those in Alberta, Saskatchewan and Manitoba which own their own telephone systems – have a long history of insisting on maintaining the status quo.

In the final analysis, therefore, it appears likely that the privatisation and telecommunications policy processes in Canada will continue to be mutually compromised in a manner that leaves Canada without the full benefits of either.

## Notes

1. CNCP Telecommunications – *Application for Exemption From Certain Regulatory Requirements*, Telecom Decision CRTC 87–12 September 22, 1987.
2. *Canadian Overseas Telecommunications Corporation Act* S.C. 1949; 2nd session; Volume 1, c.10.
3. Janisch and Schultz, 'Teleglobe Canada: Cash Cow or White Elephant?', in *Papers on privatisation*, Thomas E. Kierans and W.T. Stanbury (eds) IRPP; 1985, esp. pp.188–190, 206–208, 210–211 and 226–227.
4. Idem.
5. Supra, note 2. This section was subsequently changed to s.7.
6. Supra, note 3.
7. *Statement of Telecommunications Policy Respecting Teleglobe Canada*, Department of Communications, November 1986, p.2.
8. Letter from Hon. Flora MacDonald, Minister of Communications to Hon. Barbara McDougall, Minister of State for privatisation, December 31, 1986.
9. Canada, Minister of State (privatisation) and Minister Responsible for Regulatory Affairs.
10. See, for example, Annual Report of Teleglobe Canada, 1986.
11. *Teleglobe Canada*: An Overview, Information Services, Ottawa, November, 1986 at p.4.
12. See, for example, the statement of Hon. Barbara McDougall, of February 13, 1987, Hansard, p.3418.
13. Idem.
14. Hansard, p.3459 (February 16, 1987).
15. Ibid., p.3435 (February 13, 1987).
16. Supra, note 3.
17. Idem.
18. Hansard, p.3459-3640 (February 16, 1987).
19. See Hansard, passim. February 13-19, 1987, especially the statement by Hon. Barbara McDougall at p. 3419 (February 13, 1987).
20. The actual closing date was April 3, 1987.
21. Statement by Ken James, MP, Hansard, p.3431 (February 13, 1987).
22. Statement by Hon. Roch LaSalle, Hansard, p.3423 (February 13, 1987).
23. Statement by Sheila Finestone, MP, Hansard, p.3423 (February 13, 1987).
24. See, for example, s.13 of Bill C-38, 'An Act Resspecting the Reorgansation and Diverstiture of Teleglobe Canada', which gives the CRTC the power to approve changes in control over Teleglobe.

25. Subsequent to the writing of this paper the government announced that the two telephone companies would be privatised. As for CN's share of CNCP, under the partnership agreement between Canadian National Railways and C.P. Ltd., each partner has the right of first refusal on the other's share. It has been reported that CP would exercise this right should CN wish to sell its share (*Financial Post*, January 4, 1988, p.5).

# PART III
# TRANSPORT

# 6 Privatisation and Regulation: The Case of British Airways

**Robert Baldwin**

## Introduction

The recent history of British Airways demonstrates clearly the close relationship between the processes of privatisation and of regulation. Here I look at the way that the British civil aviation industry is controlled and the effect that privatising British Airways (BA) has had on the overall regulatory system. The issues raised and the lessons for other fields of regulation will then be examined.

## The British Regulatory System

On economic matters British civil airlines are controlled by an independent regulatory agency, the Civil Aviation Authority (CAA). This is probably the British agency that most closely resembles the independent agencies that have long been familiar to North Americans.[1] Since its creation in 1972 the CAA has been responsible for issuing transport licences to operators so as to control route entry, and it has regulated tariffs. Scheduled services have traditionally been more closely regulated than air charters which were deregulated to a large extent in the seventies.

The regulatory systems for domestic and international services differ considerably. On domestic routes the CAA licence largely determines who flies where, but on international routes the situation is more complex. For the airline that seeks to fly on international service, the CAA route licence is but one stage in a larger process. As well as the licence, the operator must obtain a route flying right derived from an air services agreement (ASA) between the British Government and the government of the relevant foreign state. Within the terms of these agreements, the governments may designate operating airlines. The ASAs, in addition, commonly provide for governmental approval of air fares and for controls on route entry.

Some tension may manifestly exist between the CAA's route licensing policies and the concerns of the government. Whether or not airline X should be allowed to fly to country Y may depend on a host of considerations that go beyond the field of pure civil aviation policy. British governments have, thus, been unwilling to delegate to the CAA the authority to conclude ASAs and these matters are still negotiated by departmental staff, albeit assisted by CAA advisors. On an international route, the airline will first go to the CAA for an air transport licence. If the application is contested by another operator, the CAA will decide the issue, usually at a public hearing. An appeal on such matters lies to the secretary of State (and airlines are increasingly prone to appeal). Once the airline has obtained its licence it will seek designation by the government under the appropriate ASA (where an agreement exists) or it will await the government's negotiation of a suitable agreement.

Under the terms of the Civil Aviation Act 1982, the CAA must pursue a number of objectives in making licensing decisions. These include encouraging British airlines to provide air services at the lowest fares consistent with safety, an economic return to efficient operators and the sound development of the UK air transport industry; furthering the reasonable interests of users and ensuring that British airlines compete as effectively as possible with other airlines on international routes. The CAA must, when considering applications for new airlines, take into account both the benefits of competition and the effect on existing air transport services of licensing a further operator.

Over the last decade, the CAA has liberalised the regulatory process and its substantive regulatory policies to a considerable extent. Charter services are largely free from entry controls, and pricing freedom is a reality for airlines. Operators may now set fares on domestic schedules routes without prior CAA approval but they must file the fares with the CAA, which may intervene should it consider this appropriate (for example as it might where predatory pricing is discovered). On route entry, the existence of an appeal to a pro-competition government has, over the last eight years encouraged the CAA to pursue competitive licensing policies. The CAA has stated that it will licence competing services by British airlines even at the risk of some impairment of

an existing British service where to do so is consistent with the objectives of the 1982 Act.

The size and the role of British Airways has, since the start of CAA regulation, been a major factor in the determination of licensing policy. In its first full scale Review of Domestic Air Services [2] in 1979, the CAA noted the scarcity of traffic on UK routes and pointed to a series of conditions favouring larger operators. It argued that lack of regulation might produce at best imperfect competition, at worst monopoly. It concluded that 'complete deregulation of domestic services is simply not feasible'. Nevertheless it argued that competition for routes could be used as a substitute for competition on routes where the latter might not be possible. The CAA staff view was that unless the position of BA was to be changed drastically, a residual element of regulation was unavoidable.

## The Privatisation Process

The Government first announced its plans to privatise BA in December 1983. It invited the CAA to review the potential consequences for competition policy and for the development of the British airline industry. The CAA treated this exercise as the opportunity for a further broad-ranging review of policy.[3] It was concerned that BA's size created a structural imbalance in the British civil aviation industry (in 1982 BA alone accounted for 65 per cent of total UK airline output and 81 per cent of output on scheduled services). BA's home airport, Heathrow, was similarly dominant, serving 45 per cent of total UK terminal passengers. In the CAA's view, BA's size and entrenched Heathrow position gave it a 'formidable advantage' over other British airlines when competing with them. This was a major national asset when the British industry was competing with foreign operators but such power could be used aggressively against other British airlines, and the CAA was not optimistic about its powers to contain such aggression:

> 'It is the dominant position enjoyed by British Airways relative to other British airlines and the ease with which its resulting market power could be abused that focuses particular concern. Experience both generally and in the airline industry shows that it is difficult to identify predatory behaviour and to anticipate its undesirable consequences through the available regulatory means. It is often difficult to distinguish between normal competitive behaviour and behaviour that is predatory in character. Thus it can be difficult to determine whether a price offered in the charter market is reasonably related to costs or offered at a conscious loss with predatory intent and it may also be difficult to determine

whether a price is newly offered or whether it is matching that of a competitor. The damage may be done before the remedy can be applied. Moreover the available remedies will tend to be either Draconian or ineffectual'.[4]

In relation to intercontinental scheduled air services, the CAA was in no doubt about the 'second force' philosophy:

'It is desirable, as a matter of aviation policy, that the United Kingdom should have a number of successful airlines in addition to British Airways, that can compete with it where the opportunity arises and exist as alternative centres of management style and of innovation, then provision should be made to ensure that they have the opportunity to survive and to flourish and in the Authority's view there are indeed powerful arguments for providing such opportunities. In the Authority's view there is a need for an alternative airline which, though relatively smaller than British Airways, is nonetheless capable of operating as a world-class airline and could replace it on a major international route should the need arise. British Caledonian is the only airline which the United Kingdom has that is immediately capable of filling this role.'

The CAA made a series of proposals designed to counterbalance BA's dominance and its 'Heathrow advantage'. It recommended inter alia, that:

1. There should be a reduction in the relative size of BA so that other British airlines could develop and so that there would be at least one airline fit to replace BA on any major intercontinental route should the need arise.

2. A series of intercontinental routes should be transferred from BA at Heathrow to B.Cal at Gatwick.

3. BA's scheduled service routes from Gatwick should be taken over by other British airlines.

4 BA's European routes from provincial airports should be taken over by other British airlines.

5. Access to Heathrow should be made available to other airlines to offer competition to BA's domestic trunk routes where competition did not already exist. BA's allowable flight frequencies should be reduced if necessary to allow such competition.

6. The CAA's powers to combat anti-competitive behaviour should be strengthened.

Alongside these proposals the CAA proposed to cease regulating domestic air fares but still require fares to be filed with it in order to prevent predatory or monopoly pricing.

The CAA did appreciate that route transfers away from BA meant that the Exchequer would have to forgo part of its return on any sale of BA but considered this to be 'a modest contribution to the sounder development of the industry'.[6] After all, it argued, the avowed aim of privatisation was the promotion of competition. The CAA, to this effect, quoted the Financial Secretary to the Treasury, Mr John Moore, who had said in a speech on 1st November 1983:

> 'We are not so naive as to think that an unrestrained monopoly in the private sector would be less inclined to exploit its position than the monopolies in the public sector. The key here is to ensure that greater competition goes hand-in-hand with returning industries to the private sector.'
>
> 'The privatisation programme is coherent, and well thought out. It holds substantial advantages for the management of the industries, their employees, the consumer and the taxpayer. And it also, of course, brings benefits to the PSBR and furthers our objectives of reducing the size of the public sector. But these important by-products are secondary to the main theme. Our main objective is to promote competition and improve efficiency.'[7]

In response to the CAA report, BA, under Lord King of Wartnaby, began to lobby powerfully in Whitehall against the diminution of BA and particularly against route transfers. The Cabinet was divided on the issue and the arguments were strongly put. Two *Observer* reporters recounted how 'Lord King was not slow to use his long-standing personal friendship with the Prime Minister'.[8] The Government's White Paper response to the CAA [9] soon indicated that Lord King and BA had won the day. There was to be no forced reduction in the relative size of BA. It was not to lose its Gatwick services to other operators, it was to keep its regional routes to Europe and, instead of the compulsory transfer of a series intercontinental routes from BA to B.Cal, there was to be a more modest and 'reciprocal' redistribution of intercontinental routes. B.Cal's Adam Thompson had but recently made a speech warning that his company could grow by being awarded the new Terminal 4 at Heathrow or, alternatively, by being given a large number of BA routes. If neither of these were granted, he said, B.Cal would inevitably merge with BA.

BA's looming privatisation swayed the political decision in spite of such cautions. The Government was planning to sell off BA once the remnants of that airline's litigation with the receivers of Laker Airways had been resolved and it was thought that the City would be less attracted to BA should it be stripped of its a number of profitable routes.

BA was sold off in 1987 on the general basis that privatisation would improve productive efficiency – that orientation towards profit would provide a greater incentive to efficiency than pursuit of the public interest as set down by statute and controlled by administrative means.[10] There were strong tensions between arguments for a more competitive environment and the case for sending to the marketplace a dominant or privileged BA. The Government, as sellers of BA, were convinced of the need to give buyers confidence in the position of BA. In January 1987 the Secretary of State for Transport wrote to the Chairman of BA to offer assurances on future civil air transport policies. He stated that the Government remained

> 'committed to a sound and competitive multi-airline industry and to the promotion of fair competition in all markets so long as the United Kingdom's interests are not prejudiced.... It is also the aim of the policy that the UK civil aviation industry as a whole should continue to include airlines strong enough to compete aggressively against foreign carriers'.

He added that the present regulatory framework would continue and ruled out any further series of route transfers that would be likely to affect BA's position. BA's own video promoting the privatisation described the airline's extensive route network as the 'jewel in the crown' of the Company.

## The Effects of Privatisation

Some of the effects of privatisation (on both consumers and the regulatory system) can at this stage only be anticipated. Others can be discerned already. It can be argued that BA's acquiring control of B.Cal in December 1987 was a product of the privatisation and regulatory processes in combination.

The CAA's proposed transfer of routes to B.Cal from BA in 1984 was to have offered the smaller operator a lifeline in accordance with the 'second force' strategy that had prevailed in British aviation for the preceding 25 years. This philosophy favoured the retention of at least one UK airline other than BA in a position to offer competition on both domestic and international routes. Following the Government's denial of new routes to B.Cal, that airline's difficulties intensified. Traffic on the B.Cal service to Tripoli fell away after the US bombing of Libya; the B.Cal network in Saudia Arabia lost out to an economic downturn in the Middle East, and West African routes

encountered currency problems. In Europe B.Cal's hopes for liberalisation were dashed in 1987 when talks collapsed between Community transport Ministers. B.Cal lost £19.3 million in 1986/7, US carriers began a spate of mergers and B.Cal Chairman, Adam Thompson, looked for partners in order to survive in the world of mega-carriers.

At the same time, BA was becoming concerned at its own position. Lord King told the press in May 1987 that the Government had failed to understand BA's international battle with other airlines and that protection should not be offered to smaller operators at BA's expense.[11] When BA heard that B.Cal were considering a merger with Italian airline Alitalia, senior staff met and a BA/B.Cal deal was eventually struck. By 16th July 1987 the BA bid had been made and received favourably.

At that stage the BA bid was worth £237 million and B.Cal had debts of about £300 million. Lord Young the Secretary of State for Trade and Industry referred the BA bid to the Monopolies and Mergers Commission (MMC) in August 1987. Independent airlines and consumer organisations were vocal in their opposition to the merger but the chiefs of BA and B.Cal spoke vehemently in its favour.

The MMC reported on the merger in late 1987 [12] and decided that, subject to conditions, it should proceed. The conditions included: the surrender by BA of all B.Cal's domestic licences and three European licences and the relinquishing of 5,000 slots at Gatwick. Lord Bethel, a member of the European Parliament and well-known crusader for low air fares, commented that the merger would be 'a disaster for consumers'. He warned that BA would use its 'fortresses' at Heathrow and Gatwick to impose a stranglehold on the charter market.[13]

A number of UK objectors to the merger lodged protests with the European Commission alleging that BA was guilty of abuse of its dominant position in Contravention of Articles 85 and 86 of the Treaty of Rome. By March 1988 the Commission had, however, approved the takeover after further concessions from BA. In addition to the commitments given to the MMC, BA agreed to abandon certain hearsay appeals; not to operate more than 25 per cent of the available slots at Gatwick, and to withdraw a number of European services.

The Minister for Aviation and Shipping, Lord Brabazon, had been concerned to monitor BA's undertakings to the MMC. He wrote to the Chairman of the CAA in January 1988, asking him to undertake this monitoring exercise and report back by the end of the year. The CAA's consequent report was published in January 1989.[14] The Authority was satisfied that BA had lived up to its commitments. The airline had in early 1988 surrendered twelve domestic and ten international route licences held by B.Cal. It had reapplied for some of the B.Cal routes at a series of licensing

hearings held in the summer of 1988 but it abandoned these endeavours after the CAA refused the first two applications The former B.Cal routes were redistributed to independent airlines, but in any event BA's own licences covered five of the domestic and three of the international routes involved.

What have been and are the effects of the privatisation/merger on the regulatory system? From the CAA's point of view the changed shape of the industry increased its role as regulator of monopolistic and anti-competitive behaviour.[15] It commented:

> 'How to identify and deal with anti-competitive behaviour is a problem which increasingly faces regulatory authorities all over the world as deregulation gathers momentum... In recognition of this we have already initiated a consultation with the airline industry to define predatory or anti-competitive airline behaviour and to work out effective means for dealing with it'.[16]

The privatisation and merger has, however, limited, at least in the short term, the CAA's regulatory options. First, as noted already, the 'second force' airline disappears and competition for intercontinental routes will be impoverished. The new BA-B.Cal grouping will control around 95 per cent of Britain's share of international scheduled airline capacity. Second, it remains unlikely, in most observers eyes [17] that remaining independents will want to set up long-haul intercontinental operations on a scheduled basis. The costs are too high and, as B.Cal found, the licensing and permissions processes are too lengthy, expensive and problematic. Third, the danger of predatory behaviour by the enlarged BA has become greater and this may encourage defensive amalgamations between other airlines. Fourth, fierce competition on shorter and European routes might be expected to continue – charter operators will ensure this.

Against these points it could be argued that the combination of privatisation and merger will effect a necessary trade-off. There might have been losses in terms of domestic competition but these have been counteracted by regulatory means and, in any case, the merger was necessary to allow BA to compete more effectively in the world market.

The argument that merger will enhance BA's world position was relied on heavily by Lord King in July 1987, when he called it an 'unrepeatable opportunity to create a British airline capable of taking on the world'. He argued that on over half of B.Cal's network there was no corresponding BA service and so no loss of competition would result from a merger. On the other long-haul routes there was substantial foreign competition and on short/medium haul routes other British airlines would offer competition.

That the merger will enhance BA's position has been doubted by a number of observers. In 1986, BA carried 17 million passengers, B.Cal only 2.4

million. A *Financial Times* leader [18] was prompted to observe that absorbing a small UK rival would make little difference to BA's world position and that BA was not seriously threatened by the series of mergers that had concentrated the US domestic airline industry. The Consumers Association, arguing for a monopoly reference [19], stated that the merger did more to cushion BA from domestic competition than to increase BA's size as a major world airline. With respect to long-haul routes, there may have been only limited competition on routes as Lord King said, but competition for routes and the regulator's option of substitution did exist. These have diminished as a result of the merger. The *Financial Times* leader, already quoted, pointed to the run-on effects of privatisation. The F.T. began and ended thus:

> 'British Airways merger with British Caledonian threatens to make a nonsense of the Thatcher Government's airline competition policy. The top priority identified in the 1984 White Paper on the subject was the promotion of a sound and competitive multi-airline industry.'
>
> 'A creditable 'second force' in British aviation is most certainly desirable. The fact that B.Cal is financially weak certainly does not prove that it is no longer practicable. It may merely show that more routes should have been stripped from BA before its public sale'.

The privatisation of BA clearly imposed new strains on the regulatory process and left the CAA with a series of difficult problems. Writing before the BA privatisation but in anticipation of it, Mark Ashworth and Peter Forsyth suggested that a number of courses were open to the smaller airlines and the regulatory agency, should BA be privatised.[20] First, mergers with other operators or non-airline companies could be undertaken so as to help resist predatory actions by BA. Second, the CAA could re-think the licensing system and consider the allocation of routes by franchising, so as to increase competitiveness, make for easier transfers of routes and decrease the ability and inclination of the dominant operator to maintain the existing route structure. Third, the CAA and government could take steps to minimise the advantages enjoyed by larger operators. This would involve principally making access to Heathrow easier or increasing the price differentials between users of Heathrow and other airports. Such responses must be recognised as of limited value in restraining the power of a dominant firm. The CAA itself considered, in 1984, the options of substituting franchising or the auctioning of licences for the existing scheme of licensing according to public interest standards. It rejected both. Franchising, it said, would involve the CAA in more close specification and control of services than at present and would lead

to more, rather than less, regulation. Auctioning, it was argued, would in practice only reinforce the existing competitive imbalance in the industry.

## Broader Issues

The above account may appear to take in a number of factors unlikely to be reproduced elsewhere or in other regulatory fields. It could legitimately be asked whether the BA/B.Cal merger can properly be put down as the result of the BA privatisation process. The link, however, is not so tenuous as might first appear. Two key decisions were taken in the 1983-4 period: to privatise BA and not to transfer routes to B.Cal from BA. As has been recounted, the relevant ministers were quite aware that privatisation was being bought at some cost in terms of competition. Others have considered the coherence of the Thatcher Government's privatisation programme and have looked at the economic and social costs of the privatisation process.[21] My concern has been to look not at how one might regulate a privatised sector but to examine the distortions that the privatisation process can be expected to impose on any subsequent regime. It is too soon to judge the final effects of the BA privatisation, but on a general basis then there are a number of points to be drawn from experience with BA.

First, practical politics leads governments to under-price enterprises that are to be sold off – this is the premium paid in order to guarantee both the success of the floatation and the continuation of the Government's own privatisation programme. Similar considerations lead governments to sustain over-protective schemes of regulation in order to ensure the attractiveness to buyers of the enterprises to be sold off. Second, it is accordingly of crucial importance to create a competitive environment in advance of a privatisation. As Ashworth and Forsyth wrote before the BA privatisation.

> 'If the Government wishes to encourage competition in the airline industry now is the time. It may be too difficult after privatisation of BA. It ought also to state its intentions on regulation for when its partner countries alter their policies. If competition is to be encouraged, and the benefits that it brings are to be secured, liberalisation must come before.'[22]

Third, where privatisation involves very large concerns, this strengthens the case for reforms in regulation that diminish the advantages of scale enjoyed by larger operators. Thus in considering schemes of franchising or the auctioning of licences, it has to be asked whether these will allow smaller operators freer access to routes than more traditional, public interest based schemes of licensing. As B.Cal found, procedural entry barriers were as

advantageous to the dominant operator as more familiar economic barriers.

Fourth, the position of the regulatory agency is highly problematic when large concerns are privatised. This point has been made in relation to the new regulatory offices such as the Office of Telecommunications (Oftel) and Ofgas. As Cento Veljanovski has argued, the 'privatisation agencies' raise newly acute problems:

> 'Whereas in the U.S.A., agencies are subject to the risk (inevitable or otherwise) or capture by the industry that they try to regulate, in Britain the regulatory system has been devised as part of the privatisation process, where those to be regulated have been in one sense part of the government machinery. The 'Capture' has taken place one step removed from the operation of the agency, in the very formulation of the agencies and the structure of the industry itself.'[23]

This comment refers to agencies that have been set up at the same time as and with the same legislation as a privatisation, but in the aviation field we saw how the regulatory system was implicitly redesigned in the course of a privatisation. Arguably what was needed was explicit and anticipatory redesigning.

Fifth, the linkage between privatisation and regulation that was seen in the case of BA further undermines arguments based on ownership alone. Veljanovski again:

> 'The attempt to frame the debate in terms of a choice between the state and the market, or between private property and state-ownership, is misguided. It is not the essence of the state that is in question but its functions. The more significant reason why contracts between private and public are unhelpful is that private property can take many forms and that the forms, or rather the restrictions placed on the exercise of ones freedom, is very much the gift of the state. The claim that private property is a more efficient form of ownership than public property is vacuous. The effects of both forms of ownership depend critically on the 'bundle' of property rights rather than mere ownership'.[24]

Offers to evaluate 'privatisation' without further elaboration should thus be treated with caution. The 'privatisation' under discussion may involve a monopoly, a dominant operator or an enterprise subject to competition from a number of equally well resourced firms. As important as the privatisation is the scheme of regulation that is to be created or that already exists. In the case of BA, not only was a clearly stated scheme of regulation and a set of regulatory policies lacking during the privatisation debate, but also the

regulatory distortions of privatisation were (for short-term political reasons?) swept under the carpet.

Sixth, a key weakness of the Thatcher Government's privatisation programme has been its lack of will or inability to break down monolithic or dominant structures. In 1983, John Moore stated:

> 'The long-term success of the privatisatioh programme will stand or fall by the extent to which it maximises competition.'[25]

Starting with the case of British Telecom (BT), however, it was discovered that political timescales made such breakdowns highly problematic. A decision was taken in BT's case to opt for a privatised monolith plus regulation as the second-best, but available, option. British Gas was also retained as a monolith, and BA became more monolithic soon after privatisation.

Seventh, the dimension of accountability should not be left out of the picture. An independent agency such as the CAA is, by virtue of its independence, not an institution that is highly accountable to public opinion. It could be contended that a body such as the privatised BA is controlled through the market and that pressure from the capital market will encourage efficiency. The point here is that insofar as the government regulates ownership of the private monoliths, the threat of the hostile takeover bid (a potent force for the attainment of efficiency) is weakened. There is an argument here for governments to go the whole way and to liberalise ownership restrictions.

## Conclusions

Three central points should be taken from the above account and emphasised. First, this was a case in which the Government believed that a protective regulatory environment had to be sustained in order to encourage a successful floatation. Little evidence existed, however, to indicate that investors would have been discouraged by measures designed to effect healthy competition. Had the Government not opted for a protective and vaguely-stated regime, rather than a more competitive but more precisely laid-down scheme of regulation, would buyers have been put off? Where future privatisations are under consideration more determined steps should be taken: (a) to calculate the elasticity of demand in relation to different regulatory regimes; (b) to develop for this purpose more clearly defined statements of regulatory intention. (Little was said during the BA privatisation of the effect on B.Cal, but the CAA and B.Cal themselves issued warnings); and (c) to adopt a timetable for privatisation that allows a suitably competitive environment to be

established in advance of sale and sufficiently in advance to allow the market to settle.

Second, since the operation of most privatised enterprises depends to a large extent on the regulatory regime in existence or to be created, efforts should be made when privatising to calculate the regulatory effects. Privatisation should thus be sold as a package with a regulatory regime not something in any sense separable. The need to revise a regulatory system to take account of the changed make-up of the industry regulated should be considered in advance of regulation. For example whether franchising rather than classical licensing would counteract the dominance that is likely to result from privatisation.

Third, the position of the regulatory agency has to be considered in the course of a major privatisation. In the case of the CAA, there was an agency of fifteen years experience that had built up policies and expertise at not inconsiderable expense. That agency advised the Government on the competitive repercussions of the BA privatisation but at the end of the day this advice was swept aside. A number of factors could account for this. For example, the timescales involved may not have catered for evaluation of the evidenced, the Government may have taken a political decision that the importance of the privatisation programme as a whole took precedence over the competitive repercussions in one field of activity; the privatisation may indeed have been a muddlingthrough in which the Government knew where its heart lay but not where this would lead it. Some combination of these three factors may offer the most convincing explanation. What was clearly demonstrated was the weakness of the CAA's position. On the one hand the CAA advocated transfers of routes in order to protect the 'second force'. On the other, it saw itself as unable to use its licensing discretion to achieve these objectives within the terms of the 1982 Act. The effect of the BA privatisation and the BA-B.Cal merger will be to increase BA dominance and place an almost unbearable burden on the CAA to police predatory actions by the UK's dominant airline. The CAA, we have seen, has little confidence in its ability to stop predation. The recent lawsuit that was settled with Laker Airways was based on allegations of BA predatory action and, it could be argued, privatisation will hardly reduce the inclination to predate; as Michael Beesley and Stephen Littlechild (who have both advised the Government on its, privatisation policies) have put it:

> 'Privatisation is intended to change motivations of management towards profit-making. A privately owned company will have greater incentive to exploit monopoly power commercially'.[26]

Instead of restructuring the British airline industry to make it more competitive, the Government has produced a situation of diminishing

competition and (it is likely) of more intensive regulation. Judged by its own stated standards it has acted in a counter-productive manner.

The further effects of the BA privatisation will emerge over the next decade. The smaller independent operators may regroup to form a 'second force' once more; the CAA *may* revise its regulatory system sufficiently radically to assure all involved that BA will not act in a predatory fashion. What will take longer to overcome is the sense of shock and uncertainty that one privatisation brought to a well established scheme of regulation.

## Notes

1. For a detailed account see R. Baldwin, *Regulating the Airlines* (Oxford, 1985) and for a discussion of regulatory agencies in Britain see R. Baldwin and C. McCrudden, *Regulation and Public Law* (Weidenfeld & Nicolson, 1987)
2. CAP 420, CAA, 1979,
3. CAP 500, CAA July 1984.
4. Ibid p.5.
5. Ibid p.9.
6. Ibid p.17.
7. Ibid.
8. David Simpson and Victor Smart 'The Jumbo and the Mouse' *Observer* 19th July 1987.
9. *Airline Competition Policy*, Cmnd 9366, October 1984.
10. See BA prospectus 1987.
11. Simpson and Smart, loc.cit.
12. Report by the MMC, *Proposed Merger*.
13. See Flight International, 21.11.87, p.4.
14. CAA 'Merger of British Airways and British Caledonian', *CAA official Record Series* 2, No 857, 17 January 1989 p.8.
15. CAA *Annual Report*, 1987-88, p.5.
16. CAA *Annual Report*, 1986-7, p.5.
17. See e.g. M. Donne 'Reluctantly B.Cal flies into BA's Slipstream' *Financial Times* 17.7.87.
18. Ibid 17.7.87.
19. See *The Times* 30.7.87.
20. M. Ashworth and P. Forsyth 'British Airways: privatisation and Airline Regulatory Policy' in J. Kay et. al *Privatisation and Regulation* (Oxford 1986), see also M. Ashworth and P. Forsyth, 'Civil Aviation Policy and the privatisation of British Airways', IFS, 1984, *Report Series* 12).

21. See e.g. J. Kay et. al. *Privatisation and Regulation – The UK Experience* (Oxford 1986), C. Veljanovski *Selling the State: Privatisation in Britain* (Weidenfeld & Nicolson, 1987); D. Heald and D. Steel 'Privatising Public Enterprise: An analysis of the Government's Case' 1982 *Political Quarterly*. 53, 333.. D. Steel and D. Heald *Privatising Public Enterprises* (London, Royal Institute of public Administration 1984). J. Vickers and G. Yarrow *Privatisation and the Natural Monopolies* (London: Public Policy Centre 1985).
22. Ashworth and Forsyth, loc.cit. p.164.
23. C. Veljanovski: *Selling the State: Privatisation in Britain* (Weidenfeld and Nicolson, 1987)
24. Ibid p.207.
25. See J. Moore, 'Why privatise?' in Kay et. al, eds. op.cit.,p.92.
26. See M. Beesley and S. Littlechild, 'Privatisation: principles, problems and priorities', in Kay et. al. eds. op.cit, p.38.

# 7 Transport Regulation and Privatisation in Canada

**Trevor D. Heaver**

## Introduction

For more than twenty years, the greatest source of strength for the development of Canadian transportation policy has been in the recommendations of the MacPherson Royal Commission, 1961. The policy recommendations of the Commission were adopted in large part as the national transportation policy set down in the *National Transportation Act* (NTA) of 1967. The Commission is the logical topic with which to commence this chapter. The application of the elements of the policy is then reviewed on a modal basis up to 1985. The release, in 1985, of new policy proposals and new regulations for each of the modes is reviewed in the final section of the chapter, again with treatment of the modal regulations. The issue of Crown ownership is considered last.

More prominence is given to railway issues than those of other modes. There are various reasons for this. It is the mode with which the author has greatest experience. It is the mode which even many Canadian shippers characterise as 'unlike other businesses' and, as a consequence, raises distinctive public policy questions. It is the mode subject to the most original regulatory change in the current legislation. Finally, I judge that it is the mode for which the outcome of the 1987 regulatory reform process is most uncertain and most critical for Canada.

## The MacPherson Royal Commission

The Commission was appointed when the inroads of competition, particularly from trucking, gave rise to major policy issues as the railways attempted to cover increasing costs from a declining traffic base. Although named as a Commission on transportation, the terms of reference for the Commission suggested a focus on railways traditional in Canada. Fortunately, the MacPherson Commission recognised the underlying conditions giving rise to the transport (railway) problems of the day.

The Commission concluded that 'most of the ills which beset transportation in Canada, particularly railway transportation – and the allegations of inequities which results – are caused by the failure of public and private attitudes to adjust to the realities of competition'.[1] The Commission's views were formulated in broad recommendations for greater reliance on competition as a national transportation policy. It recommended that:

> In brief, the broad aim of public transportation policy should be to ensure – consistent with the other goals of national policy – that all the various modes of transportation are given a fair chance to find their proper place within a competitive system. The application of such a policy is, we believe, essential if we are to obtain – at a minimum cost – a balanced and efficient transportation system which is fully adequate to meet the nation's transportation requirements.[2]

The Commission recommended reliance on competition consistent with its analysis of the economic characteristics of the modes of transport. It recommended different policies for rail and truck services. For rail, it recommended a regime allowing collective pricing among carriers, regulation to ensure that all rates would be compensatory and that rates in instances of real monopoly power were not excessive. For truck, it recommended full competition among carriers.

The Commission also gave prominence to other policies of government which affect the efficacy of competition to achieve an efficient allocation of resources. It involved two major aspects of policy:

> First, the burdens being born by any mode, because of law and public policy, must be offset by adequate recompense. It becomes a simple axiom of policy that, where the public obliges services to be continued beyond the commercial demand for them, the public shall pay. To do otherwise is to distort the true competitive competence of that mode.
>
> Conversely, if public policy confers benefits upon any mode beyond the remuneration necessary for the performance of services, that mode is

> supported to a degree which misallocates recources in its favour. Public policy must ensure that it does not, through inadequate charges for capital funds or for use of public facilities, inequitably favour any mode, or firm, over others.[3]

These excerpts demonstrate the sound and fundamental principles laid down for transportation policy in 1961. They applied directly to the rail and trucking modes. The explicit treatment of the trucking industry involved recommendations which Professor W.A. Anderson, the research director for the Commission, noted 'was to direct some very pointed comments to provincial authorities in the matter of road transport regulation, in keeping with the general philosophy of the transport policy for the nation. It may be unique, it is certainly rare for a federal Royal Commission to do this'.[4]

## The National Transportation Act of 1967

The NTA 1967 accomplished four main things. It set down a national transportation policy, which remains the foundation of policy, in the *National Transportation Act* of 1987, it implemented some measures related to subsidies, it revised railway regulations and it established the Canadian Transport Commission.

A major part of the legislation changed the regulatory regime of the railways. The railways were left free to price their services consistent with three primary constraints. They were that rates should not be less than costs, that rates for 'captive' traffic should not exceed a formula-based maximum rate and that shippers would have the right to appeal under a broad public interest criteria. The maximum rate provision followed the general recommendation of the Commission even though the limited protection provided to large shippers was recognised. Mr. J. W. Pickersgill, Minister of Transport, stated:

> 'No maximum rate formula that we could possibly devise is going to be satisfactory in dealing with the big shippers with commodity rates. We do not want – certainly I do not want – to provide shippers of that kind with an advantage written into legislation in bargaining against the carriers. It seems to me that we ought to leave them free'.[5]

The legislation made explicit the power of the railways to confer on rates. Agreement between the railways had long been practiced in the interests of uniform class rate scales, negotiating commodity rates covering multiple origins and desginations and had been required for agreed charges by the *Transport Act*, 1938.

Part III gave sweeping powers to the CTC over extra-provincial trucking, but the section was not implemented and regulation is still carried out by the provinces. Therefore, the regulation of modes other than rail was affected only cosmetically by the Act through the consolidation of powers into the new Canadian Transport Commission. However, neither that centralisation nor the research function of the CTC appear to have accelerated change in the regulatory regime of the other modes of transport.

## Experience under the National Transportation Act, 1967

The NTA, 1967 affected the railways most directly. This section then, deals with the railway experience first, before examining the development of the other modes and their regulation.

## The Railway Experience

Most important were the working of the regulatory regime and the application of the compensation principle. These are discussed first. Then, the changing attitudes of government towards the railways are considered up to 1985.

### *The Working of Greater Rate Freedom*

The railways responded quickly to the new freedom with volume and unit-train rates but only slowly used the flexibility in pricing as a complement to wider changes in service design. Nevertheless, the regime allowed the railways opportunities to experiment with pricing and service arrangements and to respond to the substantial growth in bulk commodity movements. Rates and service arrangements were often negotiated collectively by carriers and groups or associations of shippers. Rate reductions could be made effective on the conclusion of negotiations. Traffic growth, technological advances and freedom to innovate were associated with substantial improvements in productivity.[6]

The financial results, as judged by CP Rail, reflect the improved productivity. Between 1959 and 1967, the return on CP's net railway investment ranged between 2.3 and 3.9 per cent. Since 1967, earnings have improved but the cost of capital has remained substantially higher than the return on capital throughout the period. The highest rate of return was achieved in 1980 when it was 7.6 per cent. In that year, the cost of capital before tax for CP, approved by the CTC for use in costing, was 24.35 per cent. It is evident that, while CP was reporting profits, it was not earning its cost of capital.

Reliance on the commercial negotiation of freight rates proceeded reasonably satisfactorily even during the 1970s as inflation-related increases were required by the railways. The main source of concern and complaint by shippers was the lengthy process involved in public interest appeals, which were the main instruments of regulatory redress under the new regime. In a decade, less than a dozen cases were pursued to a conclusion. The majority of these dealt with the relationship among rates for different shippers.

*The Implementation of Compensation Arrangements*

The implementation of government programmes for the rationalisation and subsidisation of imposed public services provided by the railways worked less smoothly than rate freedom. The tradition of using railways as the transportation instrument in regional development was modified partially. In 1969, the *Atlantic Region Freight Association Act* (ARFAA) extended subsidies to trucking comparable to those for rail under the *Maritime Freight Rates Act*. In 1985, subsidy payments to trucking were almost twice those to railways ($49.9 million to $26.4 million). However, no programme was introduced to offset the favoured use of rail over truck in the carriage of grain in Western Canada.

The process of branch line rationalisation soon stalled in the face of community and regional opposition, especially within the prairie provinces. The government has guaranteed about three-quarters of all prairie trackage to be operated until at least the year 2000. This outcome led F.W. Anderson, who served as chairman of the Prairie Rail Action Committee, to decide the fate of some 2,344 miles of contentious lines, to observe:

> Now that it is accepted that the burden of cost of the rail system is largely a public cost the process of doing a real rationalisation job on the basic network is probably impossible. It will take more support and courage than any Political Party can muster from the West. Canada retains the high cost transport sector of the grain trade at least for another 23 years![7]

As losses mounted on railway passenger services, dissatisfaction by the railways, government and communities mounted. Eventually the federal government assumed responsibility for intercity services through the establishment of VIA Rail as a Crown corporation in 1977. VIA assumed full responsibility for the services in 1979, although it contracts for operations with CN and CP. In 1977, the total cost of intercity passenger services was $347.3 million of which the government bore 57.1 per cent, the carriers 14.3 per cent and the passengers 28.6 per cent. VIA was established in the hope

that spiralling passenger service deficits could be controlled and services improved. Unfortunately, the lack of a clear mandate and independence for the corporation have contributed to the VIA's poor record.[8]

In 1986, government payments to VIA were $506 million ($462 million operating and $44 million capital). The government's operating contribution was about 2.3 times the passenger revenue. The treatment of VIA has taken place with a railway preoccupation characteristic of freight transport policy in former decades. There is, as yet, no sign that a national passenger transportation policy will be adopted to lead to an efficient development of services making the best use of all available modes for passengers.

Finally, the experience with the carriage of grain at statutory rates was almost catastrophic. Although a study by the MacPherson Commission found that the railways lost money on the carriage of grain at statutory rates and the Commission recommended the payment of subsidies if the rates were maintained, it was not until the *Western Grain Transportation Act* of 1983 (WGTA) that a subsidy programme was introduced to compensate the railways for losses incurred. The intervening period saw the railways stop purchasing cars and investing in lines for the movement of grain. The federal government and, subsequently, provincial governments made hopper cars available to the railways without charge. In spite of that assistance, the losses experienced by the railways continued to mount so that the railways argued they were unable to invest in needed mainline capacity improvements. Shippers, especially coal exporters, were faced with the real prospect of capacity rationing by the railways limiting industrial growth. It was a shippers' coalition as well as pressure from the railways that was instrumental in overcoming the substantial resistance to change.

The WGTA introduced a basic compensation payment, the so-called Crow benefit, to the railways of $659 million per year for the transportation of grain at statutory rates. The government is also committed to other payments for branch line rehabilitation and hopper car purchases. In 1983, it was estimated that the government will have provided a total of $8.9 billion by 1992 to help prairie farmers meet the cost of shipping grain.

The WGTA continues a major constraint over the railways' commercial freedom. However, the remuneration to the railways includes a contribution to constant costs of 20 per cent. The traffic as moved is profitable but the railways are seeking some flexibility in pricing consistent with more efficient systems of shipping grain. It is widely believed that this would benefit the grain industry and the railways.

### *Shifting Attitudes Towards Railway Regulation*

Government attitudes towards railway regulation during the 1970s reveal the persistence of certain regional political attitudes in Canada. They sharpen

appreciation of the major change in railway policy in the last four years.

In 1973, at the Western Economic Opportunities Conference, the four western premiers joined to decry the effects of federal policies on regional development. Traditional views about the role of transport in economic development were voiced and specific features of railway freight rates were criticised. The prime minister acknowledged that:

> ...the west requires a broader range of employment oppoprtunities, and a greater stability of income that more secondary industry can provide and the transportation costs are the key to this...
>
> ...that's a basic principle on which there is certainly agreement.[9]

Studies of so-called rate anomalies revealed that most of them were not real but were the result of incorrect data or interpretation. An analysis of general rate policies brought forward by the provinces of Alberta and Manitoba found them to be 'exceptionally costly to the railroads and for-hire trucking, will provide excessive benefits to areas and producers not in need of such assistance and may perversely influence the western industrial structure.'[10]

Nevertheless, the federal government accepted that a more interventionist policy was required. In the throne speech of September 30, 1974 it was stated, 'Transportation must be an instrument of national policy, designed to achieve broad social and economic objectives'.[11]

In 1977 and 1978, the government introduced legislation consistent with this philosophy, which also proposed minor changes to regulatory arrangements for railway rates and provided shippers with easy access to CTC investigations. While the latter measure was widely supported by shippers, other specific measures gained little support and the proposed changes in the national transportation policy were strongly criticised by shippers and carriers alike. At the time that this Bill was failing, the United States was moving actively to deregulate transport.

Federal interest in more interventionist policy to meet regional needs waned in the face of growing conservatism in politics in Canada and elsewhere. The first rumblings of deregulation were heard in Canada even before a short-lived Conservative government in 1979. The United States was moving quickly to deregulate transport. This increased competitive pressures in Canada, particularly in aviation as many Canadian travellers could use alternate routings through the U.S. American deregulation also provided visible evidence of benefits to consumers from deregulation. The Liberal Government made a sudden policy change and become a proponent of deregulation.

The U.S. *Staggers Rail Act* of 1980 had important effects in Canada. The extra-territorial reach of U.S. antitrust legislation resulted in the cessation of collective pricing on transborder traffic. The level of many rates on transborder traffic dropped as shippers took advantage of new confidential contracts within the U.S. Ripple effects of lower rates were felt for shippers not located on U.S. lines when trucking to those lines was possible. Some commenced lobbying for similar changes in Canada.

Canadian railways were affected by the loss of some traffic and by rate reductions on other transborder traffic. In their competitive efforts, they were handicapped by the visibility of their published rates. Thus, the carriers as well as shippers were interested in a relaxation of regulations governing transborder movements. An investigation by the Railways Transport Committee of the CTC in 1984, recommended that confidential rates be allowed on transborder traffic.

The process of regulatory reform was carried forward with new vigour by the Conservative government elected with a decisive majority in September, 1984. On February 21, 1985, the Honourable Don Mazankowski, Minister of Transport of the Conservative Government, announced a programme to revise transport regulation in Canada. The CTC was to investigate the applicability of U.S.-type railway rate regulation in Canada so that a policy document and proposed legislation could be introduced and possibly passed in the fall of 1985. Although the announced timetable for regulatory reform was not met, the passage of the final legislation, in August 1987, was a notable accomplishment.

The proposals for a new transportation framework were laid down in a ministerial paper, titled *Freedom to Move*. The proposals were 'based on the principles of greater reliance on competition and market forces, a reduction of government interference and regulation, and the creation of a regulatory process that is open and acessible'.[12]

Progress from *Freedom to Move* to the *National Transportation Act*, 1987 is discussed after reviewing the regulatory regime of trucking and aviation to 1985.

## The Regulation of Motor Vehicle Transport

The evolution of the trucking industry in the 1930s from local cartage operations led to its regulation at the provincial level. As the industry grew, the legality of provincial regulation of interprovincial trucking became uncertain. The trucking industry and the provinces favoured retention of regulatory responsibility with the provinces. When a decision of the Privy Council in London declared extra provincial trucking to be a federal matter, the *Motor Vehicle Transport Act*, 1954 was passed quickly to allow the

provinces to continue to regulate all trucking. The legislation permitted the application of different regulatory policies and procedures. It created positions of potential conflict between provincial boards, each with jurisdiction over an inter-provincial operation. The result has been the evolution of a patchwork of regulations: intra-provincial trucking has not been regulated in Alberta; it has been regulated rigorously in Saskatchewan, Manitoba and Quebec. Entry into extra-provincial service has been regulated but rates have only been required to be filed in Quebec and Newfoundland. Enforcement of provincial regulations has generally been 'lax'.[13]

The recommendation for deregulation by the MacPherson Commission was opposed by the trucking industry and most provinces. The provinces were concerned with the policy of deregulation, with the loss of their powers and with the split of jurisdiction between inter- and intra-provincial operations. The *NTA*, 1967, was passed with sweeping powers provided to the CTC over extra-provincial trucking in Part III. However, Part III was not proclaimed so that the industry has continued to be regulated under the legislation of 1954. Debate has been frequent about the desirability of entry and rate regulation in the trucking industry and on the effectiveness of the current regulatory regime.

In February, 1978, a meeting of first ministers of the provinces and federal government resulted in a reference to study regulation generally being submitted by the federal government to the Economic Council of Canada (ECC). The ECC issued an interim report entitled *Responsible Regulation*, in 1979. It published a number of studies (mainly on trucking and airlines) and a summary report, *Reforming Regulation*, in 1981. In relation to trucking, the ECC recommended cessation of the 'public convenience and necessity' test. It recommended that entrance be permitted as long as carriers meet minimum requirements with respect to such matters as bonding, insurance and vehicle registration. It recommended that rate filing be abolished and that remaining regulatory matters be administered through the Canadian Conference of Motor Transport Administrators (CCMTA).[14] (Since 1977, the federal government had been working with the CCMTA to bring about improvements in the working of provincial regulation.)

The U.S. experience with regulatory reform through the *Motor Carrier Act of 1980* provided Canada with valuable lessons. Canadian carriers were able to expand and adjust their operations in the U.S. with greater freedom than was possible in Canada. (This proved a frustration to U.S. carriers who, like their Canadian counterparts, were denied the same flexibility in Canada.) However, it was Canadian shippers who saw advantages in deregulation and sought comparable action in Canada.

In February, 1985, the federal and provincial ministers of transport agreed to a programme of regulatory reform including reduced entry controls,

elimination of rate approval, the designation of special commodities exempt from regulation, and streamlining of administrative measures. These principles were included in *Freedom to Move*, as a part of the reform programme.

## The Regulation of Aviation

The regulation of all aviation in Canada is under the jurisdiction of the federal government by virtue of a 1932 decision of the Privy Council. Further, the development of aviation services has historically been closely linked with federal government initiatives since the federal government established Trans Canada Airlines (TCA) in 1937. From this time, government policy has been characterised by the perceived need to protect and nurture airline companies serving the Canadian markets.

The important role of government was continued in 1944 by the establishment of the Air Transport Board, which made recommendations to the minister on the issuance of licenses and the approval of rates. Further, TCA (which was renamed Air Canada in 1964) derived its routes from Parliament until 1977, when the *Air Canada Act* gave the airline direct responsibility to Parliament rather than reporting through Canadian National and gave it the same status as other airlines before the CTC.

The powerful role of the minister of transport in the working of airline regulation continued under the *NTA* 1967 because of the special status of Air Canada and the ability of the minister to vary or rescind any order, regulation or ruling of the CTC. For the airline industry, the government issued policy statements to which the CTC was expected to adhere in its decisions.

Air Canada enjoyed a monopoly in trans-continental routes until 1959 when CP Airlines was given limited operating authority. The restriction on CP Air's capacity on trans-continental routes was gradually reduced and finally lifted in 1979. Wardair was also allowed to operate domestic charters transcontentally in that year. International routes negotiated by government have been allocated between CP Air and Air Canada to provide those carriers with protected international territories. Wardair and Pacific Western Airlines (PWA) were given authority to operate charter flights to certain destinations.

The expansion of carriers from local services during the 1950s and early 1960s led to a regional airline policy. This policy identified five specific carriers as regional airlines. They were not allowed to compete in transcontinental services but were protected within their regions from third-level carriers.

The gradual relaxation of regulation was continued from the short Conservative government of 1979-1980 by the new Liberal regime. When Mr. Lloyd Axworthy became minister of transport in 1983, he soon

announced his intention to liberalise airline regulations and asked for the Air Transport Committee (ATC) of the CTC to conduct public hearings and set up an interdepartmental task force to examine the possibility of complete airline deregulation.[15]

Mr. Axworthy was responding to pressure for change. Airline deregulation in the U.S. took place de jure in October, 1979, with de facto regulation occurring earlier. It had two important consequences for Canada. First, many passengers travelling between Canada and the U.S. found it advantageous to start and/or finish their flights from nearby U.S. airports. The diversion of traffic to Burlington, Vermont from Montreal was the most dramatic. Second, the example of low fares south of the border led to calls for similar regulatory change in Canada.

The opportunity for the minister of transport to introduce meaningful regulatory change in air transport was available because of the special role played by government policy statements. In May, 1984, in the face of an impending national election and before either the ATC or the interdepartmental task force had published their reports, Axworthy announced 'The New Canadian Air Policy' under which licences were to be issued freely and rate reductions granted. The policy was perceived as a first step towards fuller deregulation by legislative reform. This action was left to the following Conservative government which announced its intentions in *Freedom to Move*.

## Regulatory Reform 1985–1987

*Freedom to Move* was introduced following various studies of the individual modes. However, the document simply presented policy positions, it did not support them by evidence or analysis of existing problems. Released on July 15, 1985, it set in motion a period of active consultation between interested parties and government officials.

The House of Commons Standing Committee on Transportation held public hearings across the country in November, 1985 on *Freedom to Move*. The first version of a new *National Transportation Act* (Bill C-126) was tabled in Parliament on June 26, 1986. However, this legislation died when Parliament was prorogued for the summer. Slightly revised legislation was introduced on November 8, 1986, as Bill C-18. The Standing Committee also held public hearings on this legislation which, with slight modifications, was given Royal assent on August 28, 1987. The Act came into effect on January 1, 1988.

Concern by shippers about the lobbying effectiveness of CN and CP led to the formation of the Coalition of Concerned Shippers (CCS) in early 1986.

(In 1984, a coalition of exporters formed to represent shippers had a few years of positive experience with the effectiveness of collective lobbying which had not been evident prior to 1980.) The CCS represented 14 industry associations accounting for more than $150 billion value in trade and $15 billion in freight bill payments. The vigorous efforts of the CCS, its member associations and individual shippers, were important to the support sustained for pro-competitive measures. The CCS provided shippers with a strong, uniform and stable voice. A national position was maintained. The CCS was able to build on the wide concern about the competitiveness of Canadian industries in international markets. While shippers did not see all of the pro-competitive measures they supported materialise in the final legislation, they gained more than they reasonably could have expected when Mr. Mazankowski first announced his programme of regulatory reform. A report published by the Conference Board of Canada noted:

> The increasing importance of transportation in overall corporate management has led to a keener interest on the part of shippers in transportation policy development. Reviews of transportation policy in the past have usually been dominated by carriers, with relatively little input from shippers. The perspective of shippers now appears to be changing from one of observation of issues to one of active involvement.[16]

## Regulatory Reform Not Deregulation

Deregulation in the U.S. gave rise to expectations of similar action in Canada. The common language used to characterise the expected changes was 'deregulation'. However, as proposals for change were discussed and, especially, proposals in *Freedom to Move* were criticised by opposition members of Parliament, characterisation of the process as Canadian regulatory reform became stronger. In a press conference following the tabling of Bill C-126 in June, 1986, Mr. Mazankowski stated:

> It offers a made-in-Canada approach to the need for a distinctive Canadian transportation environment. It recognises our need to promote our competitiveness and productivity while at the same time protecting essential services and improving safety in all fields of transportation.
>
> This Bill is made in Canada, by Canadians and for Canadians. Unique Canadian transportation situations are being addressed through the application of effective and innovative Canadian measures.[17]

Four days after this statement, Mr. Mazankowski became House leader for the Conservative Party: Mr. John Crosbie became Minister of Transport. The new minister stated:

> So the new policy is based on competition, on efficiency, on getting the best service for the best price for passengers and shippers. The new freedom to move, we believe, will help maintain and protect jobs in industries all across Canada.

But the Legislation is not simply deregulation. We believe it to be a balanced package, with protection for the public interest where that is really necessary and needed...

> ...We say this is a made-in-Canada policy.[18]

The application of pro-competitive initiatives in the Canadian context is evident in both the statement of national transportation policy and in the regulatory measures applied to individual modes.

## The New National Transportation Policy

The statement of national transportation policy in the *National Transportation Act, 1987* is Appendix 1. It follows the same structure as the previous statement but includes important changes. They are in the statement of objectives and in the conditions deemed necessary for their achievement.

Safety has been a made specific objective of the transportation system along with 'economic, efficient and adequate'. It makes clear that the national transportation system is expected to meet the highest practical safety standards.

The provision of 'viable and effective transportation services making the best use of all available modes of transportation at the lowest total cost is essential to serve the transportation needs of shippers and travellers' as well as 'to maintain the economic well-being and growth of Canada and its regions'. This statement now reflects carrier and user interest in the long-run viability of efficient carriers as well as users' transportation needs. Nevertheless, the user interests in services have been the prime motivation for the legislation.

The conditions under which the policy objectives are most likely to be achieved have been modified in five ways.

First, conditions for competition in the transportation industry have to be consistent with the highest practical safely standards. Safety issues have become more prominent because of the growth of hazardous goods

transportation and because of concern that greater reliance on competition among firms can lead to erosion of safety standards. While the government acted to improve air safety in 1985 by amendments to the *Aeronautics Act* and by regulations to implement the *Transportation of Dangerous Goods Act*, other safety measures lagged behind economic reform. The argument for delaying regulatory reform until safety measures were in place was voiced most strongly by the trucking industry. Changes in safety measures followed the *NTA*, 1987. The *Railway Safety Act* was proclaimed on January 1, 1989. Other measures are still pending.

Second, the objectives are acknowledged as likely to be achieved 'when all carriers are able to compete, both within and among the various modes of transportation'. This statement represents a vital change from the previous emphasis on intermodal competition. Its application to each of the modes of transport is the primary form of regulatory change in Canada. The identification of carrier as well as modal conditions is continued in the explanation of policies on compensation, user charges and features on fares, rates and conditions of carriage.

Third, the statement concerning the role of regulation has been modified to emphasise that 'competition and market forces are, whenever possible, the prime agents in providing viable and effective transportation services'. Regulation is only expected where '...necessary to serve transportation needs of shippers and travellers', and then without unfairly limiting the competitive ability of any carrier or mode.

Fourth, transportation is recognised as a key to regional economic development. As Mr. Crosbie pointed out to the Standing Committee this is 'the first time in transportation legislation there is a commitment that transportation is recognised as a key to regional economic deveopment'.[19] The inclusion of this statement reflects the continuing importance attached to the role of transportation in certain regions of Canada. Its inclusion in the legislation raised questions about its potential conflict with the viability of carriers. Consequently, a late amendment to the Act added the concept that 'commercial viability of transportation links is balanced with regional economic development objectives in order that the potential economic strengths of each region may be realised'. The significance of this new element of transportation policy remains unknown.

Finally, among the conditions required of fares, rates and conditions of traffic to avoid unfair disadvantages and undue obstacles for users is the avoidance of 'an undue obstacle to the mobility of persons including those persons who are disabled'.

## Reform of Railway Regulation

The *NTA 1987* introduces radical changes into long standing aspects of railway regulation in Canada, although not affecting traffic carried under the *Western Grain Transportation Act*. The primary effects of the legislation are the stimulus provided to intramodal rail competition, the allowance of confidential contracts and the addition of regulatory mechanisms. These are discussed prior to considering the broader consequences of the legislation. Collective pricing is disallowed by removal of Section 279 of the *Railway Act* so that the railways may only discuss rates for traffic required to move over the lines of more than one carrier (joint rates). They must price separately, on all other traffic.

Further, the reach of potential competition between railways is extended in two ways. First, railways are required to originate and terminate cars on their terminal lines for other line-haul carriers at a rate prescribed by the Agency when the originating or terminating location is within 30 kilometers (or more if the Agency prescribes) of an interchange where railway cars can be stored. This (interswitching) provision is an extension of an earlier order that applied up to four kilometers from designated interchange points.

Second, shippers accessible only to the lines of one railway may require that (local) railway to establish a competitive line rate (CLR) for the movement of traffic to a connecting carrier for the movement of the traffic to or from another location in Canada or the U.S. The CLR is calculated on the basis of the rate established by the connecting carrier pro-rated over the mileage of the local carrier with allowance for the addition of an interswitching or comparable rate. The intent of CLRs is to extend the reach of competition in rural areas. CLRs can apply for distances not exceeding 50 per cent of the total number of miles over which the traffic is moved by rail or 750 miles, whichever is greater, although the Agency may, on application of a shipper, extend the limits.

The nature of competition among railways is affected, also, by the allowance of confidential contracts. These reduce the effects of price leadership, facilitate integrated rate and service design, and lessen the influence of 'me-tooism'. 'Me-tooism' refers to the pressures brought by shippers on railways to extend to them concessions granted to others. Shippers have complained that railways have been reluctant to grant concessions to individual shippers because railways fear that, once the rate concession becomes public, other shippers might demand and be successful in receiving the same treatment. There has not been anything specific in the law that would require the railways to accede to the 'me-too' claim if the conditions and circumstances of the movements were different. However, the reference in statutes to unfair disadvantage, undue obstacle and unreasonable

discouragement, the concern for the government in the 1970s for 'equity' of treatment among users of transportation, and CTC decisions concerned with 'parity' relationships among rates, could all lend weight to concerns by the railways about rate relationships.

It should be noted that even under the new legislation, differences among rates, including confidential contracts, for the movement of similar products under substantially similar conditions are limited under Section 60 of the Act to that justified by any cost or efficiency factor. The main benefit to shippers, then, of confidential contracts is from the patent-like protection afforded to their gain derived from any productivity associated with contracts. The legislation is not designed to reward more astute bargaining per se, as some shippers hope.

The regulatory regime for rates has been revised by the NTA 1987. Minimum rate regulation has been preserved but maximum rate regulation has been repealed in view of the pro-competitive measures introduced and the range of dispute resolution mechanisms. These include mediation, final offer arbitration and rate and service investigations under comparable standards – the previous public interest criterion. There has been much debate about the working of these measures. However, Canada has retained rate regulation criteria comparable to those of the last 20 years. It remains to be seen whether the end of rate visibility wil bring to an end concerns about regional and other rate relationships. The experience to date is too short to judge.

## The Commercial and Public Policy Responses

Regulatory reform was expected by shippers to lead to a 'significant change' in railway attitudes, translated into rate and service adjustments consistent with shippers demands. No data existed on the magnitude of concessions expected but shippers appear satisfied with the early results.

Shippers and railways have entered into confidential contracts more quickly in Canada than they did in the U.S. This reflects the prior experience of Canadian shippers with agreed charges and other transportation contracts in Canada, as well as their experience with confidential contracts in the U.S. In 1988, 1223 contracts were signed. It is estimated that the contract tonnage amounted to one third and one half respectively of CN's and CP Rail's tonnage net of WGTA grain.[20] Surveys of shippers have revealed that many shippers have experienced rate reductions while service levels are perceived by most shippers as remaining unchanged, although more shippers note improvements than declines in service.[21] No quantification of the change in rates is possible. A decline was reported in revenue per tonne-kilometre for CN and CP Rail in 1988, but this reflects shifts in traffic mix and patterns as well as rate levels. The decline in revenue per tonne-kilometre

began for CP Rail in 1986 and for CN in 1987; the decline in 1988 was less than that in 1987 for both railways.[22] It appears that rate cutting as a result of increased competition has not been substantial. As the railways point out, some contracts provide for higher rates for improved service levels.

The financial performance of the railways in 1988 does not reveal to casual observation any shift in results following the 1987 Act. In its 1988 annual report, CP notes that the Act had a 'dampening effect on revenue growth'. but major changes in revenue were attributable to changes in traffic volume, especially the decline in grain traffic due to drought conditions. CP Rail's return on average capital employed was 6.7 per cent. CN's net income for 1988 was better than for 1987 but still less than CP's in spite of a larger asset base. The company actively sold its non-rail assets which leaves its viability more fully dependent on its railway services.

The results to date reflect several factors. First, responses by the railways preceded implementation of the Act. Aggressive competition from U.S. carriers for transborder traffic has been evident since the *Staggers Rail Act* of 1980, as real rates have declined and traditional rate relationships have been obliterated.[23] In the competitive process, the Canadian railways lost some market share and experienced reduced revenues from the traffic retained. It is believed that the price elasticity of traffic was not sufficient to offset the reduced revenue margins. This conclusion takes into account the elasticity of demand for the final product moved, the possibility of substituting Canadian for other moves, and the possibility of a traffic shift from truck to rail.

Second, aggressive price competition has not taken place between CN and CP, which have much in common in their cost structures and networks. Nor is there strong evidence that the more aggressive competition expected from US lines, as the reach of competition is extended by interswitching and CLRs, has had an identifiable effect on rates.[24] However, the only CLR allowed by the Agency, but under appeal by CP Rail, does involve a US carrier.

Trotter estimated that $1 billion of freight revenue might be subject to competitive access by U.S. carriers.[25] He concludes 'There is every likelihood that the Canadian railways will end up with less than the total freight movement and hence can expect less revenue'.[26] Whether the loss of railway revenue at $100 million estimated by Trotter is excessive remains to be determined.

A third factor is the high level of railway traffic. The Agency notes, 'in a year where traffic was strong and car supply tight and where railways were trying to get their own customers under confidential contracts, there was little room for the railways to aggressively pressure each other's traffic. This may not be the case in years to come.[27]

The robust economy may have smoothed the transition for the railways (and other modes) to the new regulatory environment. However, it has not

lessened the importance that they attached in 1987 to the slogan 'freedom to manage'. Shippers have supported the need to give the railways more flexibility in the control of their costs. Shippers recognise the need for adequate railway earnings and the importance of regulatory reform leading to improved efficiency and lower costs.

Expectations based on the sources and extent of efficiency gain achieved in the U.S. must take into account the greater inefficiencies imposed on the railways by rate regulation in that country prior to 1980 than has existed in Canada. Nevertheless, opportunities for cost savings lie in improvements in labour productivity, reductions in the low density railway network, and changes in regulations affecting railway operations. Many constraints on railway operations give rise to public issues, for example, the effect of hazardous goods legislation on safety and on railway costs. However, public policies affecting levels of employment and the extent of the railway system are the most fundamental matters.

Reductions in railway employment have been associated with productivity gains for many years.[28] For the period 1970-1985 Canadian railway employment has declined at an annual rate of 2.1 per cent, with rates of 1.5 per cent for the five years before the U.S. *Staggers Rail Act* and 4.2 per cent from that date to 1985.[29] However, labour still represents between 45 and 50 per cent of the real costs of CN and CP, depending on how the cost of capital is calculated. In 1986, the CN reported its intention of reducing its workforce by 23 per cent by 1990.[30] CN and CP attached great importance to achieving an agreement with their unions in 1987 which would provide needed flexibility in employment contracts. As was predictable, the clash of unions and management led to a nationwide strike which was ended by legislation.

Employment levels are affected by the development of short-line railway companies and line abandonment. In the U.S., a means by which marginal lines have been retained is to transfer their ownership to so-called, short-line and regional railways. The advantages that these enjoy are operations under newly established labour rules (generally with a non-union workforce), a cost-based ability to provide more frequent service and more personalised marketing. In Canada, the fate of short-line railways hinges on the eventual outcome of a Canada Labour Relations Board ruling that the jurisdiction of the current union applies to the new company. Maintenance of such a ruling would kill the prospect for the short-line railway solution to currently unprofitable lines. Even with a favourable ruling, short-line railways do not have the attraction for investors and financial institutions that they have in the U.S. because of much lower traffic volumes and the new exposure of lines to CLRs.

If the decision of the Canada Labour Relations Board is upheld and no action is taken by Parliament, pressures for the abandonment of railway lines

will be heightened. In any event, it seems likely that the fate of light-density lines may well be the most controversial transportation issue of the next five years.

The position of the railways is exemplified in the following statement of Mr. R.E. Lawless, President of CN:

> We have to be free to do something about our light-density rail lines. About a third of CN trackage carries almost 90 per cent of our total business, so obviously it is very productive. One third carries nine per cent of traffic, a ratio that suggests the need for close analysis. But the final third of CN trackage carries only one per cent of traffic, which means it is clearly uneconomic for us to maintain that portion of our network...
>
> The simple truth is that we in Canada have too much railway, and a lot or it in the wrong places. You might be surprised to know that a lot of those wrong places are right here in Ontario...
>
> We are now in a position where we must play 'catch-up' and depend upon the forthcoming legislation and the new regulation to allow us to be competitive with U.S. railways and with truckers on both sides of the border.[31]

In a similar vein, Mr. Russ Allison, President of CP Rail, has been reported as saying that CP wants to lop 47 per cent from its route mileage, not overnight but in an evolutionary approach.[32] Neither railway has made clear the effect that subsidies do and might have on the affects of low-density lines on their financiual status. However, the views of the CTC on current experience is relevant. A CTC report issues in June, 1985, highlighted a '...dramatic increase in the subsidisation of branch lines by the federal treasury over the period 1971-82 ($37.1 to $322 million). On the 9,929 miles of branch line track subsidised in 1982, this amounted to $32,460 per mile and an average of $1,000 per car. It was found 'that the Branch Line Subsidy programme has fostered the retention of uneconomic and inefficient transportation services at a substantial cost to the public treasury and had not given consideration to competitive methods of transport'.[33]

The government faces heightened political pressure as a result of increased applications for line abandonment. In the three years, 1985-87, the CTC allowed 1438 miles of line to be abandoned. The limit of four per cent of existing mileage that may be abandoned under the *NTA 1987* in each of the first five years would allow over 2,000 miles of line to be abandoned. Applications on this scale would see many more leadlines like 'Small towns battle to save CN rail line'.[34]

So far, the railways have not been applying for abandonment at the four percent rate, but during 1988 the Agency did not meet the time limit set down for decisions. Twenty one orders were issued in 1988 which allowed 478.62 miles (18 decisions) to be abandoned and required 169.18 miles (in three decisions) to be retained. Over 2000 miles of applications were on hand, including reconsideration of earlier decisions to retain lines and requiring periodic review. Included are all rail lines in Prince Edward Island, the smallest of Canada's provinces. Through a separate arrangement, CN discontinued all rail services in Newfoundland in 1988, and now serves the province through intermodal services. This was done under a federal-provincial agreement which provided $800 million in compensation to upgrade roads, compensate employees and improve ports in Newfoundland. Apprehension about the future course of abandonments is now increasing in several provinces and giving rise to notions of an 'essential rail network'. So far, however, politicisation of the rationalization process has not occurred and has not limited rail line abandonment, as it did following the *NTA*, 1967.

The contrast between the railway actions in the past and those projected for the future make clear the important role of the pro-competitive legislation in flushing out existing inefficiencies in the railway system, whether caused by public policies or commercial decisions. However, the federal government proceeded with highly pro-competitive legislation leaving for a later time the treatment of crucial issues which can be expected to arise. In view of the deeply entrenched attitudes of Canadians on the role of railways and transportation in the economy, how much line abandonment will be allowed? How much financial compensation can Canada afford to keep unremunerative lines open? Should compensation be paid to other modes, to users or to communities when some railway services are abandoned? What will be the implications of pro-competitive measures and network rationalization for the viability or efficiency of CN and CP as separate railway enterprises?

## Reform of Trucking Regulations

In contrast to the dramatic implementation of new regulations with uncertain outcomes for railways, the programme of regulatory reform in trucking is a hesitant and uncertain programme, but one which will have more predictable results. Also, deregulation has not been extended to the bus industry, as will be discussed later.

The federal government wished to remove rate regulation and go to a fitness test only for entry after a short period of entry regulation on a reverse onus basis. This position has been supported by the CCS. However, neither the CCMTA nor the trucking industry favour rapid change.

Trucking associations, representing the majority of their members, have

expressed concern about the impact of U.S. carriers who they believe are favoured by the U.S. tax regime and by their size and direct access to major U.S. markets. The associations have also expressed concern about the absence of adequate safety legislation. Therefore, they argued in favour of slow change to allow Canadian carrier to adjust and to provide government with time to put a safety programme in place.

The provinces have adopted difference positions on deregulation. Saskatchewan moved to a reverse onus test in 1986 for intra-and inter-provincial trucking. However, other provinces, for example British Columbia, seem unlikely to implement a reverse onus test intra-provincially because of concerns for effects on small communities. The provinces wish to maintain control over licensing criteria so that they can meet what they see as special regional or local conditions.

Industry and provincial concerns led to the Motor Vehicle Transport Act of 1987 passed in conjunction with the *NTA* 1987, providing for implementation by the provinces of a five year period with a reverse onus test, subject to review after three years, and to reliance on provincial authorities to define public interest relevant to licence proceedings. All inter-provincial rate regulation will end. The effects are to make regulatory reform dependent on provincial timetables and to allow variations in entry conditions among the provinces. This is slowing and making more complex the adaption of the industry to a more competitive environment. However, it is not stopping it. Indeed, carriers had been adjusting their operations in Canada and the U.S. in anticipation of deregulation. A trend to concentration in the less-than-truckload sector has continued because of the benefits of traffic density and network effects. Reductions of rates, due to competition, have reduced profits and have contributed to some financial failures. The share of the transborder and domestic markets served by Canadian-owned carriers remains to be seen. There are differences of opinion about the competitiveness of Canadian firms. In any event, the competitive nature of the industry seems unlikely to give rise to major problems for shippers.

## Airline Deregulation

Enactment of the *NTA 1987* had little immediate effect on the aviation industry because of the effective implementation of deregulation consistent with the government's policy announcements. Entry for Canadian controlled enterprises in southern Canada depends on possession of an aviation document under the *Aeronautics Act* and prescribed liability insurance.[35] In northern Canada an objection to a licence application may be made on the grounds that issuance would lead to a significant decrease or instability in the

level of domestic service provided in, to or from the north. A carrier anywhere seeking to withdraw or reduce service to less than one flight per week will be required to provide 120 days notice. The Agency may allow the proposed change in less time. The notice is intended to allow for commercial or policy response to the proposed change. Confidential contracts are permitted but other fares must be published. Basic fare levels and increases in the north and increases in the south where there is no alternative, effective, adequate and competitive transportation service are subject to appeal as "unreasonable".

Concern for the preservation of services to small communities under the competitive regime was dealt with by allowing the Minister of Transport to provide financial assistance if services existing on the coming into force of the Act are essential. Terms are approved by the Governor in Council. Public tender procedures for the service are required. However, services to small communities in all regions showed significant net increases during 1988. New domestic licenses were issued to 33 firms, 19 for operations for northern Canada.[36] New services were added by independent carriers using non-jet aircraft; airlines affiliated with a major carrier offered extended services with jet or non-jet aircraft, sometimes as replacement for the major carrier.

The major structural change in the industry, well underway before 1988, has been the creation of two large carrier families headed by Air Canada and Canadian Airlines International Limited. Early concern about the dominant position of Air Canada has given way to concern about the working of the duopoly of equivalent-sized carriers. In April 1989, PWA Corporation, the parent company of Canadian, purchased Wardair which had attempted aggressive growth from a charter to a major scheduled carrier. The experience appears to confirm the view that the Canadian market is insufficient to support more than two national carriers. It may also provide evidence of the barrier to entry created by frequent flier bonus point programmes provided by all major airlines in North America.

Airline capacity and the number of passengers has increased significantly in response to aggressive use of discount fares, seat sales and other incentive programmes. Competition for high-yield business traffic, while intense, has been based more on service than price. The future development of fares and competition under the duopoly is now a matter of speculation.

The major difficulty encountered in airline markets is the pressure on airport capacity at Toronto and Vancouver as passenger traffic has increased and carriers have shifted to smaller aircraft. Airport capacity constraints are putting new pressures on Transport Canada's airport policies.

## Regulation of Other Modes

Allowance of shipping conferences (cartels governing liner services) is the only departure from requiring full intra as well as intermodal competition. It is explained by the government's recognition '.... that it is not feasible to eliminate the conference system'.[37] However, the government proposed a number of measures to increase the working of competition within conferences, including the right of members to enter into confidential service contracts with shippers. Opposition from (mainly foreign) shipping lines and conflicts with the policies of other governments, led to modification of this proposal so that shipping conferences may control the use of service contracts by their members. Where confidential contracts are used, they must be filed with the Agency but no summaries will be published, unlike the publication of summaries in the U.S. The *Shipping Conference Exemption Act* of 1987 as assented to on June 30, 1987, establishes a comparable regime in Canada to that in the U.S. The legislation has had little effect on the working of conferences.

The bus industry is an even more interesting exception in the government's prog.amme of regulatory reform. No change has been made in this sector. Continued regulation of the bus industry reflects political difficulties which would be faced by the federal government in pushing for change. The existing regulations are applied by the provinces. Bus services are sensitive local issues. In spite of experience elsewhere, bus deregulation involved issues that the federal government did not want to touch. Rationalization of surface passenger transportation policy has been left for another time. It may be brought to a head in 1990 by plans to substantially curtail subsidies to VIA rail, announced in the federal budget of 1989.

## Crown Corporations

The role of Crown corporations has been a prominent and important issue since the issuance of *Freedom to Move*. It is unique as an issued on which there is great similarity of viewpoint among shippers, private carriers and Crown corporations. These groups are opposed to the continuation of Crown ownership as it has existed in the past. It is the government which has been reluctant to adjust its policy to the competitive regime that it has created.

National transportation policy is stated so that national policy objectives are to be achieved through reliance on competition and the compensation of carriers (publicly or privately owned) for uneconomic services required in the public interest. There is no special role identified for Crown corporations. Further, increased reliance on intramodal competition is inconsistent with Crown ownership. In competitive markets, Crown corporations will be

unable to recoup losses or inadequate returns resulting from government intervention. Such intervention, for example an imposed buy Canadian policy, might raise costs. If intervention holds down rates, competition from private firms will be precluded in those markets. If Crown corporations are to be favoured, through the provision of government contracts or through the writing off of debt, private firms may fail or be reluctant to enter into competition with Crown corporations. This is of particular concern to those carriers faced with competing with CN Rail in a regime allowing confidential contracts.

In spite of the logic of these arguments, the desire of Air Canada to privatize and the desire of CN to raise some (private) equity capital, the government was slow to move.[38] The government's position threatened the viability of Air Canada and CN and the effectiveness of the new national transportation policy. The unwillingness of the federal government to privatize these corporations in whole or in part was in contrast to the privatization of PWA and Quebecair by Alberta and Quebec respectively.

However, in October 1988, the government completed the sale of 45 percent of the shares of Air Canada. The sale provided Air Canada with much needed equity capital, while retention of 55 percent interest, it could be argued, retained Air Canada as a 'national carrier'. Propitious financial market conditions, a chronic government debt and lowered public concern about Air Canada as a national carrier were factors that led to the sale of all remaining shares to the public in June 1989.

While confidential studies of the privatization of CN have been carried out, no action is likely for some time. More evidence will be required on the financial performance of the railways in Canada before opportunities and pressures for change are sufficient to overcome resistance.

The scale of abandonment applications and the prospect for major questions about the rationalization of the railway network will be major issues as was branchline abandonment after 1967. The political pressures of changes proposed will likely take matters beyond the Agency to the minister and to Parliament.

## The Early Results

The early results of regulatory reform are largely favourable. In the trucking industry, the uneven application of the legislation among the provinces is causing inconsistencies but not preventing a restructuring of the industry in ways consistent with efficient service for shippers. Air travellers have been well served by deregulation, although the performance of the newly formed duopoly must be monitored. Less structural change has taken place in the

railway industry but it is here that doubts still remain about the long-run financial viability of networks deemed adequate to meet public objectives. The rail rationalization has yet to be faced at the level claimed necessary by the railways.

The dynamic behaviour of market forces is focussing attention on related government policies that affect market performance. Consistent with the experience following the *NTA*, 1967, these policies are slow to change.

Compensation and user charge policies will raise contentious issues. Particular difficulties that arise include the relevance of past investments which may no longer be economically viable, the involvement of users in investment decisions (for example, airport), and the responsibilities of provincial governments for highway investments and user charges.

The most immediate issues to be faced by the government are in areas deliberately excluded from consideration in the *NTA*, 1987. Surface passenger services have demanded attention because of concerns about the effects of VIA rail services on bus services and because of the desire of the government to reduce the subsidies paid to VIA. It is likely that decisions about rail passenger services will require consideration of policies on bus and air transport facilities and services.

The long-run effects of regulatory reform on the transportation industry will be subject to a major review in 1992 as required in the *NTA*, 1987. While the results of the early experience are encouraging, the long-run effects depend not only on the practicality and effectiveness of competition under Canadian market conditions but also on the non-regulatory policies of government. More time is required to determine whether traditional attitudes and values towards transportation and the realities of competitive markets will clash.

## EDITOR'S NOTE

Since this chapter was completed, the Canadian Government has announced major cuts in the VIA passenger services. It is proposed that the service is to be cut by approximately 50% of its current track length, in response to the need to reduce a $650 million annual subsidy bill.

## Notes

1. *Report on the Royal Commission on Transportation*, hereinafter cited as the MacPherson Commission (Ottawa: Queen's Printer, 1961), Vol. 11, p. 143.
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4. F W Anderson, 'The Philosophy of the MacPherson Royal Commission and the National Transportation Act: A Retrospective Essay', *Issues in Canadian Transport Policy*. Ed. K.W. Studnicki, Gizbert (Toronto: Macmillan, 1974), p. 62.
5. Canada House of Commons, 27th Parliament, First Session, Standing Committee on Transport and Communications, Minutes of Proceedings and Evidence, 1966, p. 2594.
6. See D W Caves, et al., 'Economic Performance of U.S. and Canadian Railroads: The Significance of Ownership and the Regulatory Environment', in *Managing Public Enterprises*, W T Stanbury and Fred Thompson (Eds.) (New York: Praeger, 1982), pp. 123-151; and J D Freeman, et. al., *The Growth and Performance of the Canadian Transcontinental Railways 1956-1981*, (Vancouver: Centre for Transportation Studies, 1987), pp. 169-199.
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16. Gordon, W.F. Jansen, *The Canadian Corporate Response to Transportation Deregulation*, (Ottawa: The Conference Board of Canada, Report 15-86). p. 30.
17. Transport Canada, Information Release, June 26, 1986.
18. Honourable John Crosbie, Minister of Transport, House of Commons, *Minutes of Proceedings and Evidence of the Standing Committee on Transport*, February 17, 1987, p. 6.
19. John Crosbie, House of Commons Standing Committee, 1987, p. 10.
20. National Transportation Agency of Canada, *Annual Review 1988*, (Ottawa: Minister of Supply and Services Canada, 1989), p. 25.
21. In a 1988 survey, 44 per cent of shippers reporterd rates had gone down and one per cent claimed an increase in rates. (Peat Marwick, *Transportation and Regulatory Reform in Canada: The Early Results*, October 1988). The Annual Review of the Agency reports that over a quarter of shippers surveyed reported an improvement in rail service in 1988 while only 12 per cent reported a decline in the quality of service.
22. National Transportation Agency of Canada, *Annual Review 1988*, p. 27.
23. Trevor D. Heaver and S. Lefebvre, 'Management Strategies under Deregulation: The Case of the British Columbia Forest Industry', *Proceedings of the 25th Annual Meeting of the Transport Research Forum*. 1984 (Oxford, Indiana: R. D. Cross, 1984), p. 44-53.
24. U.S. carriers are expected to adopt more aggressive competitive strategies because they have different conditions from the Canadian railways. U.S. costs tend to be lower although the amount is disputed and it is sensitive to exchange rates. Their route structures, traffic volumes and patterns are distinctive. Further, the threat of reprisal from Canadian firms is 'muffled' because competitive access is not required in the U.S. Therefore, U.S. carriers are not exposed in their domestic markets to the extended reach of competition from Canadian-owned lines.
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26. The Trade and Transportation Group, *A Study of Competitive Joint Line Rates*, p. 17.
27. National Transportation Agency of Canada, *Annual Review 1988*, p. 30.
28. K. D. Freeman, et al. *The Growth and Performance of the Canadian Transcontinental Railways 1956-1981* (Vancouver: Centre for Transportation Studies, 1987).
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30. 'CN Rail Will Reduce Work Force by 16,000 in Next Four Years', *Traffic World*, September 15, 1986, p. 71.
31. 'Changing the Rules' Remarks by R. E. Lawless, President and Chief Operating Officer, CN, to the Rotary Club of Toronto, April 25, 1986.
32. 'CP Wants to Axe 13,000 km of Track', *Transportation Business*, September 1986, p. 2.
33. Canadian Transport Commission, *The Nineteenth Annual Report of the Canadian Transport Commission 1985*, p. 18.
34. 'Small towns battle to save CN rail line' *The Globe and Mail*, August 13, 1986, p. A19.
35. Southern Canada is defined as that area south of the 50th parallel east of the Manitoba/Ontario border to the 53rd parallel on the Manitoba/Saskatchewan border and the 55th parallel on the Saskatchewan/Alberta border and then along that parallel to the Pacific Coast.
36. The National Transportation Agency of Canada, *Annual Report 1988*, p. 51.
37. Transport Canada, *Freedom to Move* (Ottawa: Minister of Supply and Services, 1985), p. 44.
38. See for example, 'Air Canada Sale Won't Fly', *The Globe and Mail*, August 22, 1987, p. B1 and B4.

# APPENDIX I

## National Transportation Act 1987 – Section 3

## National Transportation Policy

3. (1) It is hereby declared that a safe, economic, efficient and adequate network of viable and effective transportation services making the best use of all available modes of transportation at the lowest total cost is essential to serve the transportation needs of shippers and travellers and to maintain the economic well-being and growth of Canada and its regions and that those objectives are most likely to be achieved when all carriers are able to compete, both within and among the various modes of transportation, under conditions ensuring that, having due regard to national policy and to legal and constitutional requirements,

(a) the national transportation system meets the highest practicable safety standards.

(b) competition and market forces are, whenever possible, the prime agents in providing viable and effective transportation services,

(c) economic regulation of carriers and modes of transportation occurs only in respect of those services and regions where regulation is necessary to serve the transportation needs of shippers and travellers and such regulation will not unfairly limit the ability of any carrier or mode of transportation to compete freely with any other carrier or mode of transportation,

(d) transportation is recognised as a key to regional economic development, and commercial viability of transportation links is balanced with regional economic development objectives in order that the potential economic strengths of each region may be realised.

(e) each carrier or mode of transportation, so far as practicable, bears a fair proportion of the real costs of the resources/facilities and services provided to that carrier or mode of transportation at public expense.

(f) each carrier or mode of transportation, so far as practicable, receives fair and reasonable compensation for the resources, facilities and services that it is required to provide as an imposed public duty,

(g) each carrier or mode of transportation, so far as practicable, carries traffic to and from any point in Canada under fares, rates and conditions that do not constitute...

(i) an unfair disadvantage in respect of any such traffic beyond that disadvantage inherent in the location or volume of the traffic, the scale of operation connected therewith or the type of traffic or service involved.

(ii) an undue obstacle to the mobility of persons including those persons who are disabled.

(iii) an undue obstacle to the interchange of commodities between points in Canada, or...

(iv) an unreasonable discouragement to the development of primary or secondary industries or to export trade in or from any region of Canada or to the movement of commodities through Canadian ports, and this Act is enacted in accordance with and for the attainment of so much of those objectives as fall within the purview of subject matters under the legislative authority of the Parliament of Canada relating to transportation.

# PART IV
# FINANCIAL SERVICES

# 8 Deregulation and Reregulation of the Financial Services Industry in the UK

**Roy Croft**

## Introduction

It may appear to be something of a paradox that part of a colloquium on 'Privatisation and Deregulation in Britain and Canada' should be devoted to an explanation of the new, much more comprehensive and more detailed regime of regulation of the financial services industry currently being introduced in Britain. Before describing the main features of the new regulatory regime , therefore, this chapter will to try to identify the underlying reasons which have caused both deregulation and reregulation to be pursued, more or less simultaneously, in this particular part of the UK economy. First, however, a brief reminder of the form which deregulation of the UK markets has taken.

## The Process of Deregulation

Deregulation, as in other sectors, has been mainly a matter of removing structural barriers and obstacles to freer competition in the provision of financial services. The most dramatic move was, of course, the so-called 'Big Bang' at the London Stock Exchange in October 1986 which brought to an end restrictions of three important kinds: the system of fixed minimum commissions; single capacity trading; and the barrier to ownership of

exchange member firms by outside companies. But there have also been other significant developments elsewhere in the financial sector: for example, new legislation covering building societies which gives them, in principle at least, much greater scope to compete in the provision of a full range of financial services at the retail end of the market.

In response to these moves in the direction of liberalisation, there have already been far-reaching changes in the structure of the industry and it is clear that the process of rapid structural change and consolidation still has some way to go. Britain has never had anything equivalent to the Glass-Steagall Act to keep commercial and investment banking separate and so there has been no statutory impediment in the last year or so to the formation of very large financial conglomerates covering virtually every conceivable function from high-street retail banking, through corporate finance activities, to the making of markets in equities and other stock exchange securities. There has been a very substantial increase in the involvement of overseas firms in the London market: for example, many of the most patrician of Stock Exchange member firms are now the subsidiaries of leading American, Swiss and French banks, while the largest Japanese houses have been adding rapidly to their resources in London.

Competition for business, especially the business of big institutional clients, has greatly intensified; and although there has been a very marked increase in trading volumes since Big Bang, and market conditions have generally remained buoyant, there have inevitably been some casualties. As in other industries in the past, the firms that have proved most vulnerable have been those which have lacked the capital and other resources necessary to compete successfully on an international scale, but yet have failed to identify a convincing niche strategy for themselves enabling them to concentrate their skills on a particular segment of the market place. So far, the failures which have occurred have been relative ones and have resulted only in abandonment of over-ambitious objectives or, in one or two cases, mergers in somewhat uncomfortable circumstances. It must obviously be one of the aims of the regulatory authorities to ensure that the consequences of competitive failure continue to be dealt with in a controlled way, without damage to the rest of the industry or the investing public.

## Reasons for Reregulation

From what I have just said, it will be evident that the British Government's decision to put in place major legislation – the Financial Services Act – to provide for a new regulatory regime was not forced on it by a serious scandal resulting in widespread losses to the public. There was some disquiet seven or eight years ago following the uncovering of one or two fraudulent schemes

which occasioned losses to quite a number of investors. That was sufficient to persuade the Government to invite Professor Jim Gower to become a kind of one-man Royal Commission on investor protection. There have also been a few similar relatively small failures since then [and with the advantages of hindsight we can now see that at the time Parliament was considering the Financial Services Act, several serious failures of the previous system of regulation still remained to be uncovered]. But although the Gower report was a remarkably thorough and persuasive document, I am sure that Professor Gower himself would be the first to recognise that the speed with which the Government acted on his recommendations owed much to a number of powerful external factors. In my view, there were three which were particularly important.

## Internationalisation

Firstly, there was the rapidly increasing internationalisation of the financial industry. Modern communications and information technology mean that it is less and less possible to put a ring fence round a national financial market and force business to remain within that ring. With the easing or (as in the UK's case) the abandonment of exchange controls by many advanced countries in recent years, competition between the world's leading financial markets has intensified. For example, earlier this year the London Stock Exchange (or, as it has now rechristened itself, the International Stock Exchange) decided to begin trading in shares in the form of American Depository Receipts (ADR). It was reported at the time that a number of leading British companies (or what one still tends to think of as 'British' companies) now have a significant proportion of their equity held in ADR form, so that it is as readily traded in New York as in London. The figure is said to be as high as 45 per cent in the case of Jaguar, 40 per cent for Reuters, and about 15 per cent even for ICI and Glaxo. And since London owes its importance as a financial centre above all to its attractiveness as a place in which to do international business, it is not surprising that the London financial community has become more and more an international financial community.

As suggested earlier, Big Bang has itself led to a big increase in overseas involvement in London, so that, for example, the Chairman of the International Stock Exchange now comes from a firm which is owned by a French bank, while his counterpart at the Securities Association (which is to be the self-regulating organisation for those who deal in the securities and eurobond markets) is employed by a Swiss bank. So the time is long since past when the City had the same kind of ethos as a gentlemen's club, where everybody of significance knew everybody else and codes of conduct hardly

needed to be written down because anyone who worked for more than a few months in the City assimilated them by a kind of osmosis. Nowadays the industry is composed of firms and people from a very wide diversity of backgrounds, many of whom have been accustomed to operating in environments where what is permitted and what is not are defined in precise legal terms. And experience has shown that competitive pressures can strain the gentlemanly habits of the domestic players to breaking point and beyond. In such circumstances it was obviously increasingly difficult – and increasingly dangerous – for us not to have a clearer, more comprehensive and statutorily based form of regulation in Britain too. As the Deputy Governor of the Bank of England suggested:

> Competitive pressures in the City have encouraged in banks a tendency to have less regard to traditional standards and instead use every inch of latitude the law allows. At the same time, many long-standing practices have themselves come under scrutiny for their acceptability in today's markets – even though they have been accepted without question for many years.

Inevitably, there are those in the industry who lament this and feel that we are suffering from a kind of Gresham's Law, with good, old-style self-regulation and self-discipline being driven out by the baser coin of legalistic rules and regulations. Whether in the City's golden age self-regulated conduct was always so pure and scrupulous as is sometimes now suggested may perhaps be questionable. What is clear is that traditional codes of conduct can no longer be relied on as adequate in themselves. Moreover, many people in the industry recognise that the absence of an effective, statutorily based system of regulation in Britain would have become an increasing handicap to the industry in its efforts to capture international business. Customers overseas, especially in North America, seem increasingly to be looking for the kind of assurance and protection which the Financial Services Act regime is designed to give. And in the absence of such a regime it seems likely that we should also have experienced growing encroachment into our markets by foreign regulators seeking to protect their domestic investors or to pursue the overseas activities of their domestic firms. The growing international complexity of financial business certainly requires closer co-operation between regulators internationally if financial failure or business malpractice in one country is not to spread its infection around the world. Such cooperation can much more readily be achieved between regulators operating within similar, statutorily defined, systems.

## Diversification

The second main development in the industry which clearly influenced the Government's decisions on regulation is the rapidly increasing diversification of financial businesses. It has become a commonplace in recent years to talk about the formation of 'financial supermarkets', able to offer a full range of services both to the general public and to professional and business clients. But one effect of all this has been to create within these new multi-faceted firms many more, and more complex, forms of conflict of interest. Take, for example, the research departments of the old, stockbroking firms, many of them highly expert and widely respected. In the days of single capacity there was no doubt that their job was to provide a service to the clients of the firm; to attract agency business by convincing customers that they could profit by relying on the excellence of the firm's advice. But now many of them have been transferred to multi-capacity firms. Are they still there to provide a service exclusively to clients? Or are the firm's market-makers to be allowed to draw on their advice? And if advice is allowed to flow both ways, how is the client to be protected against blatant 'front-running' by the firm – or in other words what is to prevent the less reputable firm from taking a large position in a particular stock in the knowledge that a favourable research report is about to be circulated to clients which will give the apparently disinterested advice that the stock is a good buy? The widespread feeling that these new and more complicated conflicts needed to be carefully controlled was another of the main factors which caused the Government to give high priority to the Financial Services Act.

Diversification has also made some of the new conglomerates subject to unaccustomed kinds of risk and more difficult problems of management control. A bank, for example, which has determined to become a leading market-maker in international equities will be exposed to a whole range of market-related risks which may be quite unfamiliar to its senior management. Overtrading in equities by the market-making arm of a large conglomerate could not only endanger the viability of that group itself, but could spill over and cause widespread damage to the industry as a whole – the kind of systemic failure which banking supervisors have long regarded as their prime duty to prevent. This again has pointed to the need for a regulatory regime for the securities industry in which financial regulation and sophisticated capital adequacy requirements would be a prominent feature.

## Privatisation

Thirdly, the very success of the Government's privatisation programme made it necessary to introduce a more effective regulatory regime. There can be no

doubt that the privatisation programme has greatly increased the interest of the general public in Britain in owning equities, and, more generally, in putting their savings into a much broader range of investments than was the case a few years ago. If I may allow myself a personal reminiscence, I was part of the team which was responsible for the privatisation of British Telecom in 1984. That was the first occasion on which a deliberate effort was made to develop a widespread public interest in the offer of shares. A market research firm was used to keep track of the impact the advertising campaign was having and I recall that the last report we received from them before the prospectus was published suggested that if all went well we might get as many as a million individual investors applying for shares. We all thought that that would be a very satisfactory outcome, considering that at the time the British company with the largest number of individual shareholders was ICI which had something like 350,000. In the event, of course, there were not one million but nearly two and a quarter million individual applications for BT shares and that figure itself has been made to appear modest by the even greater popularity achieved by several of the subsequent privatisation sales. As a result, there are now many more relatively unsophisticated investors in this country prepared to be more adventurous in the way they deploy their savings than was the case even five years ago. From many points of view this is no doubt a welcome change. But it could all too easily go sour if these unsophisticated investors were to be persuaded by the less responsible or less reputable operators in the industry to divert their life savings into forms of investment which are simply not suitable for the small investor – from British Telecom say into highly speculative foreign mining stocks.

Nor is it just a matter of seeking to protect the public from high-pressure salesmanship by the unscrupulous. The small investor needs to be given adequate, objective information on which to base a well-considered choice between the much wider range of investment opportunities now available to him. And if he wishes to seek independent expert advice, he should be able to expect that that advice will be genuinely independent and not biased by undisclosed commercial ties between the adviser and one or more of the companies whose financial products are being offered. Professor Gower's report and the public discussion which followed showed that in this respect in particular the existing situation was far from satisfactory.

So once again there have been powerful pressures at work at the retail end of the financial market giving urgency to the need for a more comprehensive and effective system of investor protection.

## The New Regulatory Regime

So much for the background to the passing of the Financial Services Act. The Act is very long and detailed with a central provision making it a criminal offence, punishable by up to two years' imprisonment, to carry on investment business in the United Kingdom without authorisation. In addition, any agreement entered into by an unauthorised business is unenforceable against the other party to it.

Authorisation is available by three main routes: businesses may achieve it by becoming members of a recognised self-regulating organization (SRO); or, if, they are professional firms, by obtaining a certificate from a recognised professional body (RPB) (the Institute of Chartered Accountants, for example, decided to seek RPB status); or they may apply directly to the Securities and Investments Board to which the Government has delegated most of the regulatory powers and responsibilities provided for in the Act, and which in all essential respects resembles the kind of statutory commission responsible for securities regulation in a number of other countries. Thus, the new system attempts to preserve the best features of practitioner-based regulation, through the SROs and RPBs, but within a firm statutory framework.

The process of authorisation subjects businesses to three initial tests – of their commercial integrity, their competence and their financial viability. It should therefore make a big contribution in itself to improving investor protection by making it more difficult for the dishonest, the incompetent or the under-capitalised to continue to do financial business. But beyond these initial tests, all authorised businesses are subject to continuing regulation: they are required to make regular returns to their regulatory body, complaints against them will be investigated and, perhaps most important, they will be liable to receive periodic spotchecks and inspections.

## Rule books

For the most part, this continuing process of regulation will be based on rules – in particular, rules on how investment business is to be conducted, rules on capital adequacy and firms' financial administration and rules on the safeguarding of customers' money. The regulators (SIB, the SROs and the RPBs) will monitor compliance with the rules; many of the complaints made by customers will relate to alleged failure to comply with rules; breaches of rules will lay firms open to disciplinary sanctions up to and including withdrawal of their authorisation and also to court action for the remedying of losses suffered in consequence of breaches; and individuals found guilty of

serious contravention of rules may be banned from carrying on investment business altogether

Inevitably, therefore, much of SIB's resources in the initial stage of its existence have had to be devoted to the creation of a comprehensive rule book, covering all kinds of investment business. In this process of rule-making, SIB has had to be guided by the requirements of the Financial Services Act which lays down in some detail the principles of investor protection which must inform the rules. The list of requirements includes the promotion of high standards of integrity and fair dealing; the provision of sufficient financial and other information to enable customers to make informed investment decisions; the proper protection of property entrusted to firms; the disclosure of material facts; and the keeping and availability for inspection of adequate records. Proper provision has also to be made for firms to be required to subordinate their interests to those of their customers; to act fairly as between customers and to have due regard to their customers' circumstances. In addition, the rules have to take proper account of the fact that provisions that are appropriate for regulating the conduct of business in relation to some classes of investors may not be appropriate in relation to others, by reason of their knowledge, experience or otherwise.

Against this background, it is not perhaps surprising that the SIB Rule Book has developed into a long, detailed and complex document. (These are, in any case, characteristics which it shares with other comparable rule books both within the UK and internationally). To take just one example of additional complexity that has arisen from efforts to make the rule book more appropriate to the great range and diversity of the financial services industry, successive rounds of consultation with the industry, consumer organisations and other interested groups led SIB to distinguish between seven different classes of investor, whose knowledge, experience or circumstances are sufficiently distinct as to justify different treatment by the rules.

Moreover, it has to be said that 'final' is very much a relative term in relation to the SIB Rule Book. In reality, no rule book will ever be final which attempts to cover the activities of such an innovative and rapidly-changing industry as financial services. Inevitably changes will prove necessary in the light of experience: despite all the efforts already made to consult practitioners, some rules will no doubt create unforeseen problems for the industry; others will not have the desired effect in terms of investor protection; and new problems and situations will continually be arising. The Financial Services Act does, however, deliberately provide procedures for rule-making which give SIB sufficient flexibility to change rules rapidly in the light of developments and after due consultation. SIB has undertaken that it will keep the impact and operation of the rules under continuing close review and be ready to propose changes as and when they may appear necessary.

[In fact, by June 1989, a series of amendments to the 'final' SIB Rulebook had already been made in response to pressure of the kind foreseen in the previous paragraph. In addition, SIB had launched a major review of the Rule Book, with the aim of simplification and clarification. It is the intention that the new Rule Book should have a three-tier structure. The top tier will consist of about a dozen broad principles (e.g. a firm should act with due skill, care and diligence in the conduct of its investment business) intended to establish a common basis of standards of conduct to be expected of all firms carrying on investment business. The second tier will be composed of core rules, perhaps about fifty in number, which will also apply across the whole spectrum of the regulatory system. The third tier is intended to leave more flexibility in the hands of the self-regulatory bodies to adopt a mixture of rules, codes of conduct and guidance which will take account of the particular characteristics of their different sectors of the industry, while giving adequate effect and support to the more general regulatory reguirements set out in the principles and core rules. The UK Government has announced its intention to amend the Financial Services Act to facilitate the development of this new structure.]

## Recognition of Regulatory Bodies

Meanwhile, the 'final' SIB Rule Book has set the standard which other regulatory bodies in the new system have to match. SIB received applications for recognition from five prospective self-regulatory organisations and nine professional bodies. To achieve recognition, all of them had to have rule books which afforded investors protection at least equivalent to that afforded by SIB's rules. [However, the UK Government's proposed amendments to the Financial Services Act will relax this requirement of 'equivalence'. SIB will instead have to judge whether the contribution of principles, core rules and third-tier provisions applying to a particular SRO's members will provide adequate protection to investors.]

The other requirements SIB has to take into account are set out in some detail in the Act. Particular attention is paid to the adequacy of the resources available to a prospective SRO or RPB, to ensure that it will be capable of monitoring the activities of its members and, where necessary, taking prompt action to enforce its rules and safeguard investors' interests. A body seeking recognition also has to convince SIB that it is sufficiently independent of its industry membership and determined to promote and maintain high standards of commercial integrity and fair dealing.

## Criticisms of the New System

This brief description of some of the main features of the new regulatory system will no doubt have been enough to show that what is currently under construction in the UK financial services industry is a very complex and elaborate piece of machinery. Others may be better placed to offer criticisms of what is being done than someone who is at the centre of the construction process. But it would not be right to end this summary without acknowledging that some misgivings have been expressed, particularly in recent months. They can perhaps be summed up in the form of two questions;

(i) is the new system too elaborate to be really effective?

(ii) is it going to impose such burdens and constraints on the industry in the UK as seriously to impair London's position as a leading international financial centre?

In response to the first, it has to be admitted that one of the consequences of the Government's original decision to try to preserve a substantial element of self-regulation within the new system has been to produce a very decentralised regime, with the job of day-to-day regulation being delegated to a considerable number of practitioner-based bodies – five SROs, nine RPBs, to say nothing of the stock exchange and the various commodity and futures exchanges which also have a regulatory role.

Practitioner-based regulation has many advantages, but there is also a price to be paid. With so many different bodies involved, it will need a lot of effort and goodwill to ensure that consistent standards are achieved across the industry as a whole and that there is not unnecessarily onerous regulation or excessive bureaucracy. And the need for co-operation between regulators is going to extend beyond the boundaries of the Financial Services Act system itself. As the banks and building societies, for example, are only too well aware, their activities will be subject to two different regimes of statutory regulation – to the Financial Services Act regime so far as their investment business is concerned, but also to the Banking Supervision Department of the Bank of England, or the Building Societies Commission for their more traditional activities.

To avoid unnecessary duplication of effort, particularly in the area of financial supervision, the concept of the 'lead regulator' has been developed. The intention is to have a single reporting point and a single monitoring system for the capital adequacy of banks and other businesses whose operations straddle the boundaries of two, or even more, of the regulatory bodies. Good progress has been made in developing the lead regulator

concept into practical working arrangements, but as with the new system as a whole, the acid test will come as the strains of actual operational experience begin to be felt. Certainly it will remain one of SIB's main responsibilities to try to ensure that this and all other elements of the new system are properly co-ordinated.

[After a year's 'actual operational experience' the lead regulator arrangements appeared to be working reasonably well. There remains much work to be done, however, internationally as well as within the UK, to achieve satisfactory convergence between the differing approaches of banking supervisors and securities regulators in the area of capital adequacy.]

Finally, to put the second question in a slightly exaggerated form, will the industry survive? The process of deregulation described earlier has exposed the industry to a whole series of radical changes and intensified competitive pressures. Managements have been working immensely hard to take advantage of the new competitive opportunities being opened up and to develop viable commercial strategies for the future of their businesses. It would be understandable if some of them felt that the imposition of a new regulatory regime – which can easily be caricatured as something aimed only at the small fringe of disreputable operators in the industry and of little relevance to the honest majority – was a quite unnecessary addition to their burdens. It is also clear that, because of their other preoccupations, some managements have begun only quite recently to focus their attention on the demands which the new regulatory regime will be placing on their particular businesses. As a result, practitioner input to the detailed development of the new regime may not have been quite as extensive as would have been desirable.

There has, however, been a great deal of practitioner input, not least from members of SIB's Board, two-thirds of whom are drawn from the industry itself. The need to hold a careful balance between on the one hand the requirements of investor protection, particularly in retail markets, and on the other the necessity of ensuring that the industry retains the flexibility and commercial freedom to continue to expand and prosper in the UK has been very much in mind throughout. A well designed, well administered regulatory system should, indeed, contribute to the future success of the UK industry by enhancing its international reputation for ensuring fair dealing. There is no doubt room for the details of the new regulatory regime to be improved as experience of its effectiveness in operation accumulates. Flexibility will be needed in the early stages on the part of both regulators and regulated to ensure that necessary adjustments are made.

**EDITOR'S NOTE**

More recent material has been inserted thus [ ].

# 9 Deregulation of Canada's Financial Sector

**Jill Bodkin**

## Introduction

The year 1987 when this paper was originally delivered, marked the beginning of real competition within Canada's financial sector – competition among firms now allowed to conduct business in each other's former preserves, and competition with international firms previously barred from entry to the Canadian marketplace. The impact of policies only recently adopted remains to be seen. This chapter will describe the changes, their intended purposes, and the process of their introduction. For future commentators on public policy, the chapter will conclude with the tests which unfolding events should meet, as a contribution to the ongoing research agenda.

The analysis and opinions are my own, based on insights drawn from my intensive involvement in the Canadian process. This engagement, spanning the dramatic events of the 1980s, was as the British Columbia Deputy Minister responsible for regulation of financial institutions, and later as founding Chairman of that province's tribunal charged with regulation of securities markets. This was a unique vantage point, since financial institutions and securities dealers, as well as their regulators, have until recently been relatively insulated from one another in Canada.

## Regulation of the Financial Sector in Canada Prior to the 1980s

Regulation of Canadian financial firms has had the primary purpose of sustaining depositor and investor confidence. In common with most free enterprise democracies, Canadian governments responded to the worldwide impact of the 1929 Wall Street crash by introducing legislation designed to sustain public confidence so as to keep the public's savings at work through deposits or investments which eventually find their way to financing commerce and private or public projects .

It is important to understand that, philosophically, the Canadian approach to financial regulation has been more influenced by American values than British traditions. Canadian commercial legislation is typically extremely detailed in outlining transactions allowed, and under what conditions. Canadian governments have given regulators responsibility for public oversight, including statutory powers of supervision and intervention in the affairs of financial firms, although self-regulation on the part of the industries has contributed greatly to the effectiveness of regulation. As will be seen, the effectiveness of such interventionist powers has occasionally been illusory.

Firms conducting financial business in Canada have been separated into what are known as the 'four pillars' – banks, insurance, trust, and securities functions – with core functions reserved for companies who specialise in one or another type of business.

A further feature of the Canadian scene has been an inclination towards protection of the Canadian financial marketplace for domestically owned companies. Canadian public policy has been heavily influenced by the fear that our relatively small, open economy will be controlled from elsewhere. Hence, both governments and financial firms have historically considered Canadian control of our capital markets a prerequisite for independence of our economic fate.

Lastly, the Canadian constitution has strongly influenced the regulatory framework. Supervision of banking is a federal responsibility, which has been exercised by the Inspector-General of Banks with exclusive authority over chartered banks. The Inspector-General has always worked closely with the central bank, the Bank of Canada, which charts the course of monetary policy.

At the other end of the spectrum, regulation of securities dealers has been in the bailiwick of the provinces. This is derived from provincial jurisdiction over matters related to property rights. The federal government has occasionally argued that securities markets are national, and threatened a federal system of securities regulation, on constitutional grounds of their interprovincial trade and commerce powers.

In between, trust and insurance companies are subject to federal and provincial regulation, dependent on jurisdiction of incorporation and operation. As financial instruments have been sold across firms, and as financial conglomerates have formed, the question of which jurisdiction regulates what has become confused.

The public attitudes which underlie the fabric of Canadian regulation are in marked contrast to the traditions which have led to the regulatory framework for activities of the City of London. Britons have long understood that capital from elsewhere, and the conduct of international financial business, create essential employment for British services and people. Certain integration of financial services has been a feature of firms operating in London, largely free of externally imposed regulation. British legislative tradition has codified transactions subject to regulation only in response to particular problems rather than in an attempt to predict every ill which might beset the public. The financial community in Britain has understood that its performance will determine the world's confidence, although the imposition of stronger regulations there only slightly predated the scandals which illustrated the intolerance, worldwide, of financial insiders' use of privileged information to their own profit, at the expense of the public shareholder.

At any rate, regulation of Canada's financial sector was based on legislation which had remained stable since the 1930s.

The range of policy purposes served by that legislation includes:

- protection of deposits
- assurance of financial institutions' abilities to meet obligations through requirements for capital adequacy, liquidity and solvency
- disclosure to investors
- protection against conflict of interest and self-dealing
- assurance of financial capacity and integrity of owners, directors, and management of financial firms
- vigorous capital markets
- occasional instruments of monetary policy
- protection of the Canadian market for the domestic industry.

The overriding justification for regulation of financial firms has been that they are using other people's money on a basis of high leverage of the owners' capital. Therefore, they must be subject to public oversight, through self-regulatory bodies, backed by government authorities.

The separation of functions into the 'four pillars' has been argued as necessary to prevent the jeopardy resulting from conflict of interest.

The 1980s have seen two forces at play. First, the financial community worldwide has been subject to deregulation and international competition. Second, failures of financial firms have increased pressure for strengthened public protection. Canadian governments have responded to these sometimes conflicting pressures with a fundamental re-examination of the regulatory framework.

## Canada's Financial Sector

Prior to reviewing the process of deregulation, it is useful to understand the makeup of Canada's financial sector.

Among the various segments of Canada's financial community, each enjoys a particular strength. The banks are strong nationally and internationally, and world-wide subsidiaries of Canadian banks have operated successfully as investment bankers. As well as Britain and the United States, both Japan and the People's Republic of China are important target markets for Canadian banks. Canada's insurance firms are well connected internationally, and non-Canadian owned insurance firms have enjoyed success in Canada. Our securities firms have ensured strong Canadian capital markets, with several playing an important role in international markets. Trust companies offer important financial services, with interesting recent competition for non-Canadian business in the management of estates and trusts. Credit unions are well positioned in the domestic market, especially in Saskatchewan, British Columbia and Quebec. Recently formed financial conglomerates are strong nationally, and several have subsidiaries active outside the country in activities like merchant banking. Certain firms have found a market niche as research boutiques or portfolio managers.

Although foreign firms have traditionally been limited in their access to the Canadian markets, they have operated fully in institutional markets exempt from regulation. Experience with Schedule B banks (non-Canadian banks permitted entry on the basis of up to 8 and later 16 per cent of the domestic market in Canada) has demonstrated the advantage of increased competitiveness to business and individual customers of the banks.

Taken together, the Canadian and foreign firms operating in our financial sector have a great deal to offer. Their location here is in no small part due

to the competitive advantages of Canada itself. This advantage is demonstrated by the desire of the world's most important financial firms to enter our market, and massive inflows of capital. We have a broad range of firms, from the venture capital to the large institutions, with four stock exchanges, and well developed professional support. There has also been a recent decrease in concentration, in spite of the relatively small size of our domestic market.

Canada enjoys a high regard in international financial circles, despite periodic jeopardy to that reputation caused by the difficulty faced by our federal and provincial governments in establishing a consistent regulatory scheme. Even the failures experienced over the recent recession were relatively minor, in the perspective of worldwide experience.

Several cities enjoy particular niches in the Canadian financial community. Toronto is recognised in the international community for commercial and institutional financing, and is a natural magnet for the growth of Canada's penetration of large scale markets. The Canadian banks' share of the world market has consistently been in the order of 5 to 7 per cent, with much of that done from a Toronto base.

Montreal demonstrates the determination of French Canadian businessmen, backed by the support of Quebec governments, to use opportunities to finance Quebec enterprise as a base for the growth of Quebec based financial institutions. The fear of Quebec separatism in the 1970s caused a shift of financial activity from Montreal to Toronto. The subsequent decade has been marked by a deliberate effort to build both indigenous and international financial activity in Montreal. One example of forward looking legislation is the Quebec Stock Savings Plan, which offers incentives for public financing in Quebec based businesses. The success of Montreal is a credit to the vision of men like former Ministers Jacques Parizean, who led the way to deregulation in Canada, and Claude Castonguay, who has built the Laurentian Group, a large financial conglomerate. The strength of the Desjardins movement (cooperative financial institutions) is a legacy of earlier visionaries.

Many even in Canada have not yet noticed what is happening in Vancouver, where the financial and commercial sector is growing rapidly. Activity on our venture capital exchange has increased dramatically. In 1986, $700 million dollars was raised (more than double 1985), with a third going to finance non-Canadian Centures. 1987 saw 1.3 thousand million dollars raised, with a levelling off at slightly less than 1 thousand million dollars per year since. More than a third of the investors are non-Canadian, including major European institutions. More than 30 per cent is in non-mining ventures. Trading volume in 1987 was close to 4 thousand million dollars, now down to over 3 thousand million following the 1987

decline. We recently welcomed the major commitment of the Hong Kong and Shanghai Bank, who bring more than a century of acumen in worldwide trade finance, plus strong capitalisation, to their investment in the Bank of British Columbia.

Calgary is a centre for oil and gas financing, and Winnipeg has a commodity exchange, reflections of their primary economic base. Canada has telecommunications and transportation systems which work. They are well linked to Pacific Rim, United States, and European centres. In world political terms, we are a stable middle power, not likely to place capital from elsewhere at risk of seizure. All of these factors led to the conclusion that financial services are important to Canada's future prosperity. Firms operating from Canada are well positioned to penetrate export markets, as well as to serve the growing domestic market.

## Pressures for Deregulation

Given the international character of financial business today, it is increasingly difficult to contain firms within our borders, and to insist upon compliance with regulatory concepts which are artificial to the international community. As footloose as their clients, including Canadian multinationals and governments (who were already dealing extensively on world markets), financial firms will transact business wherever it is most advantageous.

Banking has become increasingly global through several cycles. First, banks followed multinational corporations around the world. Later came recycling of petrodollars through Euromarkets and sovereign loans to third world countries. Now we are experiencing a massive recycling of Japanese savings invested in the world's markets.

Securitisation, where instruments between ultimate suppliers and user of funds are repackaged and assume value, is an important feature of current financial markets. This arose as banking margins became too thin because of cost of funds to banks. Many corporations have found that they can raise money without bank intervention.

Also, as interest rate and currency fluctuations have become key determinants of profit or loss, there is a need to hedge against these exposures. For instance, the rise in the Canadian dollar has had an effect on sales of our forest products into the United States. Companies require hedging instruments. These instruments assume liquidity and are traded for their own potential value.

There is also a trend for industrial firms to seize opportunity for profit in the financial intermediation field. US computer giants like IBM and Honeywell are jumping off from leasing into other financial services.

British Petroleum formed its own bank. Japanese firms like Sony, facing reduced profits from traditional export of products with the rising value of the yen, are making higher profits from financial dealings. Air Canada shows its credit card subsidiary, En Route, as an important profit centre.

Computerisation and telecommunications are enabling mass retailing at low cost, twenty-four hour trading and the choice of worldwide locations to conduct transactions.

As did firms operating in the City of London, Canadian financial firms have recognised the importance of deregulation to their ability to compete. However, the attitudes have been coloured by a valid fear on the part of Canadian firms, which are small on a world scale, of annihilation as non-Canadian firms penetrate the Canadian market. Prior to deregulation the total capitalisation of the Canadian securities industry, for instance, was less than that of Nomura. As we enter the deregulated era, the industry attitudes are more accurately characterised as reluctant acceptance of the inevitable.

Government attitudes have developed from explicit policies protecting the domestic financial industry and segments within it, through a clear recognition of the advantages of greater competition to Canadian individual and corporate clients of financial services. Governments have also been concerned that worldwide financial developments should not leave Canada behind.

## Pressures for Stronger Regulation

Ironically, the current decade has seen pressures for stronger public protection, as a result of several failures experienced. Two noteworthy cases illustrate shortcomings in regulatory statutes, as well as in the capacity of regulatory authorities.

The case of Crown Trust, a formerly sedate company operating in the estate management, deposit-taking and lending fields across most of Canada, sparked the political impetus for reform. It was purchased in 1983 by a group of financiers. Investigations indicated that they had used depositors' funds for financing their own buying and selling of real estate assets on the basis of inflated evaluations. Ontario, as the government of primary jurisdiction, passed emergency legislation to provide authority for their superintendent to take control of the assets. The Canada Deposit Insurance Corporation (CDIC), a federal agency funded by members' organisations to insure the first $20,000 of each deposit, was faced with a decision whether to wind down the business, at a major cost of the insurance payouts, or to subsidise the transfer of the ongoing business to another firm. The financial assessment was worsened by a retroactive

raising of the insurable limit to $60,000 per deposit, as a measure judged essential to shore depositor confidence in the heat of the crisis. In the event, the CDIC determined that the least cost alternative was a transfer of the business.

This case demonstrated the inadequacy of early warning systems, the lack of remedial powers to prevent such failures, the danger of self-dealing in narrowly held financial institutions, as well as the difficulty of mobilising federal and provincial decision making mechanisms were jurisdiction is shared, and the need for increased resources and improved calibre of regulatory bodies.

As Canada experienced the recessionary pressures, the value of assets of lending institutions declined dramatically. In western Canadian provinces, affected by decreases in natural resource prices and sales, property and commercial loan portfolios were eroded. While most Canadian lending institutions which operated nationally had sufficiently diversified portfolios to withstand the shock, the effect was devastating to the balance sheets of those operating primarily in the west.

The 1985 failure of the Canadian Commercial Bank, in spite of an injection of funds from the major chartered banks and governments, further shook the confidence of commercial depositors. In an attempt to preserve the viability of regional deposit-taking institutions, the federal government decided to pay out all deposits beyond the $60,000 CDIC insured limit, as the bank was wound down. A legacy of this decision is the consumer expectation that there is no risk attached to the choice of where to place deposits.

Although they represent only part of the restructuring we experienced, these two cases illustrate the key problems which led to public pressure for tighter regulation of the financial sector. Crown Trust demonstrated the risk to the public's funds from potential abuse on the part of those responsible for financial institutions. Such abuse could arise from willful action or negligence on the part of owners, directors, management, or professionals engaged by the firm. The Canadian Commercial Bank was the first of several failures which also revealed the risk to solvency and liquidity attached to narrowly based loan portfolios, vulnerable to inevitable shocks in the economy.

Because governments were determined to safeguard public confidence in the financial system, the cost of the shakeout (over a thousand million $Can) was borne not by depositors, but by governments which subsidised either payout of uninsured depositors or transfer of ongoing business to other firms. Through increased CDIC premiums, some of these costs have been passed on to member institutions. CDIC has also managed transitions and liquidations so as to recover some of the loss.

This experience lent political determination to the requirement for fundamental reform of financial services regulation, reform which would have been necessary as the industry restructured itself, in any case.

The delicate balance required was that which would provide for sound financial firms which also have the flexibility to offer competitive financial services desirable for their Canadian customers. Further, the measures to strengthen public protection were needed to foster Canadian firms' ability to compete globally. The risk was that Canada be left a backwater.

What followed was a period of review of policy issues by federal and provincial governments, with wide involvement of industry groups.

## Reviews of Regulation in the Financial Sector

Although the chartered banking system had been subject to periodic review, the 1980s reviews widened the focus to the whole financial sector. The progress of industry and government examination of deregulation and reregulation in the financial sector during the 1980s was informed by an array of committees. Most involved public hearings and submissions to bodies commissioned by governments, followed by draft legislation or policy papers. Committees of Parliament and legislatures have been intensively involved.

Federal reports which chronicle the debate include:

- Federal Trust and Loan Discussion Paper – July 1982
- Wyman Report on Canada Deposit Insurance Corporation – April 1985
- Green Paper on Regulation of Financial Institutions – April 1985 (with Technical Supplement – June 1985)
- Report of the House of Commons Standing Committee on Finance, Trade and Economic Affairs – November 1986 (with further amendments – June 1987)
- Senate Standing Committee on Banking, Trade and Commerce Report on Deposit Insurance – December 1985
- Senate Committee Report on a More Competitive Financial Environment – May 1986

- Report of the Mr. Justice Willard Estey Commission of Inquiry into the Collapse of the Canadian Commercial and Northland Banks – June 1986

- Minister of State for Finance – Proposals – New Directions in the Financial Sector – December 1986

Ontario reports include:

- Ontario Securities Commission Report on Access by Financial Institutions to Discount Brokerage Services – October 1983

- Report of the Dupre Task Force on Financial Institutions

  - Interim Report – December 1984

  - Final Report – December 1985

- Ontario Securities Commission Report on Entry Into and Ownership of the Securities Industry – February 1985

In other provincial jurisdictions, governments issued discussion papers, policy statements and draft legislation, subject to open processes of public review.

The federal agenda was driven by, first, a longstanding concern to modernise regulation. In the case of insurance and trust company legislation, the concepts had not changed since the 1930s. The Bank Act is normally subject to a decennial review, which would not have seen changes until 1990. Although there was some appetite to consider expansion of powers of financial institutions, failures in the financial sector kept strengthened regulation as the predominant issue until late in 1986. Quebec's already successful deregulatory action, combined with Ontario's announcement of opening the securities business to other financial firms and non-Canadians, prompted Ottawa to move simultaneoulsy on action to increase competition and broaden powers of financial firms.

As part of this decade's resurgence of Quebec's business community, early measures were launched in support of the development of their financial sector. Former Minister of Finance Jacques Parizeau engaged the Quebec financial community in support of measures to encourage firms to diversify and to attract international business. Examples were the 1984 opening of the securities business to non-Canadian firms, followed by the 1986 registration of the first full service securities subsidiary of a Canadian chartered bank. Legislation allowing insurance companies to open

subsidiaries, for activities such as deposit-taking, was passed in 1985. Legislation to fully open competition in financial services, including to commercial firms, was passed in 1989.

Ontario agendas developed simultaneously with those of Ottawa. This reflects, in no small part, the existence in Toronto of the bulk of head offices of Canadian financial institutions. Until it became clear that global forces required Canadian financial firms to open their markets to non-Canadian competitors as the price of our continued strong presence in the world, Ontario accepted as given their 1971 policy that the financial sector should be Canadian controlled.

British Columbia, motivated by a trade related interest, maintained policies which allowed non-Canadian and non-industry access to particular segments of the financial sector. Firms operating across the Canadian commercial marketplace, however, were reluctant to take advantage of these powers, since such action could preclude them from being licensed to conduct business in other jurisdictions.

On the reregulation front, most Canadian jurisdictions worked closely together. There is a strong desire to achieve uniformity of legislation, to ease companies' access to Canadian markets, whatever their jurisdiction of incorporation. Given the vagaries of legislative timetables, and the low political priority attached to often complex commercial legislation, uniformity is an elusive goal.

## Financial Sector Response

Over the early 1980s even the more conservative firms operating in the financial arena were aggressively positioning themselves to compete in expanded markets. Those who survived the recession were strengthening their capitalisation. Conglomerates were forming, made up of financial and, later, non-financial interests. Through holding companies, firms were ingeniously moving ahead of the regulators. As in many other Canadian sectors, strong national firms are necessary to serve the small market spread across such a vast geography as well as to compete in an export market.

While individual financial groupings of firms were crossing the boundaries of the 'four pillars', their trade associations came only reluctantly to accept the desirability of deregulation. Positions changed only through 1986-87. The delay in adopting this attitude may account for the more measured pace of Canadian action in comparison with the 'Big Bang' in Britain.

Industry associations and self-regulatory bodies were very involved with governments in developing measures to strengthen the soundness of the

financial system, reflecting the overall Canadian concern for improved regulation. Companies operating in the financial sector recognise now, more even than prior to the recent years' experiences, that their prosperity depends on public confidence in the Canadian financial sector.

## Goals of Regulatory Reform

The public policy issues raised in the context of 'reregulation' of financial services are:

- improved consumer protection
- protection against abuse resulting from self-dealing or conflicts of interest
- assurance of the soundness of financial institutions
- appropriateness of ownership of firms operating in the financial sector
- standards of care for owners, directors, managers and professional advisers
- monitoring capacity and early warning systems available to regulators
- regulatory powers, particularly in the area of prevention
- involvement of self-regulatory bodies
- need for market discipline in deposit insurance and comprehensive schemes
- harmonisation of federal and provincial legislation and regulatory activity

## Legislative Action

After what seemed to many of us involved as a frustratingly long period of examination, governments in Canada are bringing in legislation in the late 1980s to implement both deregulatory and reregulatory goals. In the Canadian tradition of accommodation, governments were attempting to satisfy diverse interests. The fact that the Quebec agenda was ahead of the

rest of the country, particularly in opening competition in the financial sector (including to commercially linked firms), placed strains on the federal-provincial fabric. Later, the federal preoccupation with the Canada – US free trade agreement and sales tax reform pushed financial services legislation off the agenda until 1989. In the heat of politics, commercial reform legislation, already stale, was easier to delay than trade, over which the 1988 election was fought.

On the deregulation front, most Canadian jurisdictions have now embraced the concept of expanded powers to allow firms to operate across the 'four pillars'. Quebec led the way with its Insurance Act of 1985, and its proposed trust and loan legislation. The federal government signalled its intention later in 1987 (still delayed) to amend bank, insurance and trust company legislation to allow them expanded commercial lending and securities underwriting powers. Ontario revised securities regulations to allow non-securities firms to enter the field effective July 1987. Trust and loan company legislation has been passed. Although this legislation broadens investment powers, it has been controversial, in that it imposes higher capitalisation standards than other jurisdictions. Because of Ontario's dominance, it effectively imposes these standards on firms which operate elsewhere, as a condition of their licence to do business in Ontario. The British Columbia Securities Commission has allowed non-securities firms to enter other financial fields. A new financial services act to cover insurance and trust companies followed, including legislation to provide for captive insurance companies.

Ontario's announcement in June 1986, that non-Canadians would be allowed up to 30 per cent ownership of Canadian securities firms, was the first salvo in the crumbling of the protective wall around our domestic securities industry. The federal government, alarmed at a provincial initiative which affected the trade talks with the United States, declared their intention to preserve jurisdiction over any measure with international implications. Ontario-federal negotiations led to an agreement in April 1987. The basis of this agreement was that the Ontario Securities Commission would regulate securities activities conducted through subsidiaries of non-securities firms, with the federal government regulating securities activities of the parent. Decisions on entry of non-resident firms, by then eligible on a phased basis for full access or 100 per cent ownership of a Canadian dealer, would rest with the federal government. This was seen to protect federal jurisdiction over international trade, and to enable Canada to protect the interest of Canadian firms seeking access to markets of other countries as a condition of access to Canada.

This agreement also satisfied the federal government's interest in controlling diversification and investment of federally regulated financial

institutions. An issue which has not yet been satisfactorily resolved is whether it is necessary to subject transactions among large, institutional investors to detailed regulation, by either level of regulator.

In spite of having peripheral involvement in the negotiations, the other provinces were outraged at an agreement which effectively denied their jurisdiction over securities matters. While the federal-provincial tension built, provinces continued to license new entrants to the securities business in accordance with their policies. The federal Superintendent of Financial Institutions oversees securities activities of federally regulated financial firms, unless conducted through provincially regulated subsidiaries. Initially, only two non-Canadian entrants, Goldman Sachs and S.G. Warburg, were approved by the federal government. Companies proceeded on the assumption of full deregulation, which placed enormous pressure on all jurisdictions to bestow legitimacy on their operations. In the meantime, the federal policy explicitly provided for entry of foreign firms, and most of the world's largest securities firms now operate in Canada.

Although financial firms will enjoy access to expanded markets, they will be subject to tighter regulatory controls. Owners, directors, managers, and their professional advisers will bear responsibility for the soundness of the firm. In some cases, their obligations to shareholders will be tempered by obligations to depositors and/or regulators. A commission of the auditing profession has been examining the implications of this dichotomy in the role of the auditor. Banks have strongly resisted the intrusion of independent directors into their corporate governance, but the federal government has held firm on their intention to require independent directors' involvement.

Although proposed federal and provincial legislation has receded from earlier outright bans on self-dealing and transactions involving conflict of interest, most such transactions would be outlawed or subject to regulatory approval. Legislation requiring separation of lending and underwriting in different subsidiaries also deals with the creation of 'Chinese walls', preventing information about customers from being passed from one subsidiary to another. In recognition of the argument that no amount of legislation or regulation will present abuse, companies are required to establish internal reviews involving independent directors, as a part of the increased standard of care expected in the governance of financial firms.

The question of widely held ownership, as a protection against abuse, has been particularly controversial. No single interest has traditionally been allowed to own more than ten per of chartered banks. This has not been so in the case of foreign banks and other financial firms. Several of the families predominant in the Canadian economy control conglomerates with wide ranging financial and commercial interests. Federal policy has been intended to prevent future formation of financial entities with commercial links effective December 1986. Existing conglomerates are grandfathered,

but must have at least 35 per cent of their voting shares publicly traded and widely held by the end of 1991, or within 5 years of reaching a $50 million capital threshold. Although this provision may curtail abuses which threaten solvency, the prohibition against commercial links places Canadian firms at a competitive disadvantage with foreign firms who enter the Canadian market, in spite of such affiliations in their parent firms. Provincial legislation to date does not preclude such affiliations, leaving an interesting prospect of federal companies seeking provincial incorporation. Quebec and the western provinces are courting commercially linked financial institutions.

Virtually all Canadian jurisdictions are strengthening the powers of their regulators, upgrading the calibre of people in these offices, and supporting them with better resources, in the quest for early warning and preventive measures. The federal creation of the Office of the Superintendent of Financial Institutions symbolises these moves. Most Canadian governments now have a junior Minister of Finance responsible for financial institutions.

The Canada Deposit Insurance Corporation has also been strengthened. Board members are drawn from persons experienced in the private sector. Earlier calls for full integration of CDIC with the regulatory body have been resisted, to preserve CDIC's role as the protector of the insurance fund. CDIC has an incentive to keep the pressure on the regulators to monitor and take action to prevent failures which result in payouts. On the other hand, should insolvency make a windup inevitable, CDIC will be motivated not to prolong the life of an institution, no matter how politically desirable for the minister responsible for the regulatory authority. This tension has proven its utility, and the model is similar to that between Securities Commissions and the securities industry-operated National Contingency Fund, which pays money owing investors in the case of a firm's insolvency. Compensation funds are now being developed in the property and casualty insurance field. An ongoing agenda item for such funds is the development of market discipline to prevent excessive risk on the part of insured firms. Instruments such as co-insurance or risk related premiums are under review.

Federal-provincial cooperation is of utmost importance. Until 1985 there was no forum for regular meetings at the ministerial level. While ministers responsible for financial institutions have declared their commitment to harmonisation, conflicting economic aspirations among Canadian provinces continue to threaten agreements, no matter how great the ministerial good will. Officials level coordination is well established and increasingly institutionalised towards the goal of avoiding duplication. The level of achievement remains to be seen.

The western provincial Ministers signed an accord in 1988 to make regulation of financial institutions more compatible across provinces, and to share information for regulatory purposes. Other provinces joined in this agreement in April 1989. The federal government has been invited to a meeting of Ministers, which has a goal of presenting a common national front and pressing the federal government for early bank, trust company and insurance legislation.

Long accustomed to working closely with regulatory authorities, financial firms and associations assume as much self-regulatory responsibility as allowed. The industry advisory committee on the Canada-US trade negotiation now focused on GATT and bilateral consultation with the EEC and Japan, has demonstrated the vision which can influence governments to expand market access.

Current reforms, taken together, promise a sound Canadian financial system, enriched by competition which should operate to the advantage of Canadian retail and commercial customers.

## Key Comparative Issues

This section of the paper will highlight some features particular to Canadian deregulation of the financial sector.

The federal-provincial dimension of the policy, legislative and regulatory process is a notable difference from the United Kingdom. The past decade has illustrated the difficulty of reaching national political consensus, particularly where jurisdiction is shared.

Federal initiatives have reinforced the importance of action in the national interest, on the trade front, for instance. While there is a reasoned argument that exclusive federal authority for financial regulation is justified on the constitutional basis of federal responsibility for trade and interprovincial commerce, the fears of central Canadian domination and federal insulation from business reality render an exclusively federal authority unlikely.

The ominous prospect of further federal-provincial discord continued to represent a very real threat to the momentum behind legislative and policy changes. Canadians are often told by the international financial community that the greatest single threat to our reputation is the inability of our federal and provincial governments to reach agreements which will enable firms to operate consistently across the Canadian commercial marketplace. The implementation of certain measures, previously in jeopardy because of the exclusion of the other provinces from the agreement between the federal and Ontario governments regarding regulation of new players in the securities business, has now fallen prey to joint provincial action without direct federal involvements.

We must accomplish a unified system which does not subject firms to duplication of regulation, or confusion regarding requirements. The concept of delegation of powers holds some promise for keeping this issue out of the constitutional courts.

The 1987 Meech Lake accord provides a constitutional framework for provinces to adopt varying measures in pursuit of common national goals. This agreement, now ratified by the federal and eight provincial governments, allows for opting out of national programmes if provinces wish. There is, however, a fear that balkanisation is inevitable in the wake of Meech Lane, and that the financial services impasse illustrates the risk. It is hoped that the cooperative spirit of Meech Lake will add momentum towards harmonisation of regulation.*

In a unitary system such as in Great Britain it has been easier to proceed with resolve.

Canadian financial regulation is also marked by a more entrenched system of government regulators than in the United Kingdom. While self-regulatory bodies are a critical element, their function is much more circumscribed. The concept of the British Securities and Investment Board, as a private corporation created by statute, but operating heavily through recognition of selfregulatory organisations' own oversight of the members' activity, has considerable appeal. At a point in time when the public have been satisfied that government and industry intolerance of excesses on the part of members of the financial community can provide effective curbs, Canada would benefit from moving towards such a model.

Trade issues have heavily influenced Canadian deregulation. Because we are early in the process of opening our Canadian markets to non-Canadian firms, it has been essential to assure ourselves that levers are still available to control monetary policy and to influence our domestic economy where realistic. The federal Ministry of Finance keeps a strong hand in the trade negotiation process, with services now on the trade agenda internationally.

However, our susceptibility to global forces dictates the maximum participation of Canadian firms who can compete internationally. The tactics of negotiating reciprocal access for Canadian firms has been a preoccupation of the federal government and the financial community. In the Canada–United States free trade negotiation, Canadian firms pressed for breakdown of barriers between banking and securities firms in the United States Glass Steagall Act, and for access to the full United States banking market across state borders. Encouraging forces are at play in the United States towards the same end, but American commitment to effective legislative action was seen as a prerequisite to increased involvement of United States firms in the now more deregulated Canadian market.

Similarly, Canadian firms are seeking greater effective access to Japanese markets as a precondition for federal licensing of Japanese firms to do business in Canada.

In the historically international United Kingdom capital market, such issues do not exist. Indeed, because Canadian firms enjoy free access to the City of London, there is no reciprocity issue with regard to British securities firms' entry into Canada. Pressures from the EEC for reciprocity could further open Canada to the UK banks.

The price exacted inevitably means greater penetration of Canada's banking market by non-Canadian banks, beyond the 16 per cent previously. The Canada–United States free trade agreement allowed full access to United States banks, but lowered the limit to 12 per cent of the Canadian market for banks from elsewhere. Another pressure point will be for relaxation of the guidelines which requires pensions and other trustees portfolios to invest 90 per cent of their funds in Canadian instruments. To date, there has been no movement in the face of pressure from our trading partners on this front.

As the trade in services negotiation evolves through GATT, the principle of national treatment seems to predominate. This means that foreign financial firms would receive treatment no less favourable than domestic firms. As domestic firms see that national treatment, in Canada's deregulated environment, subjects them to foreign competition, they are pressing for strengthened access to world markets.

Several other issues appeared more important in Canadian deregulation. The payment of uninsured depositors of financial firms raised public pressure for strengthened regulation to limit future exposure of the public purse, and contributed to the willingness of governments to better fund regulatory bodies. However, it is also important that consumers understand the limits of deposit insurance.

The fear of abuse through self-dealing or conflict of interest was more intense in Canada than in Great Britain at an earlier stage. However, the late 1986 insider trading scandals led to similar pressures for government intervention in the United Kingdom, as well as in the United States and Canada.

A comparison of deregulation in the financial sector with that of other sectors yields several observations. As in transportation, the theory is that decontrolled access to the market will be marked by improved competition, to the advantage of the customer. It is to be hoped that the success of North American transportation deregulation in opening feeder airline routes will be repeated in the financial sector. However, we must be prepared for the same restructuring within the financial industry as we have had in the transportation industry.

Regulation in other fields also affects the competitiveness of Canada's financial sector. Since access to national and international telecommunications systems is critical to the conduct of financial transactions, the pace of deregulation in both sectors must proceed in tandem. As in telecommunications, national borders are illusory and it is difficult to contain business within a particular regulatory jurisdiction. This underlines the importance of international cooperation among regulators in the fields of both telecommunucations and finance.

Professional services in support of financial business must be available. For instance, long standing barriers to interprovincial affiliation among legal firms in Canada are inconsistent with the way in which financial commercial business is done worldwide. Pressures are now leading to dismantling of such barriers, and professional firms are amalgamating into national and cross-border firms.

## Conclusion

This chapter has reviewed the evolution of Canadian policies regarding deregulation of access to Canadian financial markets, as well as strengthened regulation of the soundness of the Canadian financial system. Since implementation in Canada has been more recent than in the United Kingdom, judgements regarding effectiveness will remain for later observers.

However, it is useful to describe the tests which might be applied.

Canada's financial sector must continue to enjoy the confidence of Canadian customers and the international financial community. This will result directly from the soundness of the firms operating in Canada. Both Canadian and non-Canadian financial firms must profitably serve the domestic market, and have the capacity to compete worldwide from a Canadian base. Canadian companies raising capital should enjoy competition on both price and instruments available. Canadian depositors and investors should benefit from safety of their funds, subject only to the risk associated with the instrument rather than that derived from negligence or abuse on the part of the firm. The interest of insiders must not prevail over the interest of the customers.

Canada's financial system should play a vigorous role within a regulatory system which makes most effective use of business and government resources to predict and manage risk. Given the importance of financial markets to the overall economy, the ultimate test of the current reforms will be the competitiveness and stability of the Canadian financial sector.

## Postscript

The dramatic stock market decline the week of October 1987 put reforms and firms to the test. The fact that both Canadian and British financial systems came through intact is a credit to the quality of the reforms and the people responsible for them.

Public protection becomes even more important in a declining market. There is a greater temptation for firms to earn money on the fringe of respectable practice when profits based on inflated paper values become less available. Whether or not this occurs, investors who had been drawn into the 1986-87 bull market have strengthened public pressure for sound investor protection as they experienced decreasing values of their holdings.

British privatisation and Canadian deregulation bumped head on over the British Petroleum issue, to which three of the major Canadian securities dealers had subscribed at pre-October 19 prices. The potential loss risked impairing the capital base of the firms, and the Canadian securities industry as a whole. This experience showed the fragility of the whole system, with the diversification which had occurred, but also the resilience which results from strengthened access to capital. In the event, the securities firms survived, with greater impetus to conclude budding mergers of securities firms with larger Canadian and non-Canadian financial players. During 1988, most of both large and small securities firms were bought by larger securities firms or banks.

On the federal-provincial scene, the companies negotiations with federal and provincial regulators of terms of access to various financial services sectors reveals a great deal about the evolving policy on a case by case basis. As the jurisdictional dispute wears on, Quebec at one point refused to license banks in the securities business. Given the policy interest of Quebec in encouraging diversification, this ironic position seemed merely tactical, since bank-owned securities firms are now fully operational in Quebec.

The federal government's eventual policy of openness to foreign securities firms was accomplished through licensing of individual firms simultaneously with negotiation for reciprocal access of Canadian firms. The federal policy against financial and commercial links has been called into question by a 1989 approval of American Express as a Schedule B Bank, an event which has outraged Canadian financial institutions prevented from commercial operations.

The Canada–United States free trade agreement provides for full access of United States banks to the Canadian market. Although there is no immediate pressure for United States penetration of a currently saturated Canadian domestic market for commercial banking services, this will

undoubtedly create pressure from other GATT trading partners for lifting of the overall limit for foreign banks.

Although the United States did not provide privileged access for Canadian financial firms over their domestic firms ineligibility to cross commercial and investment banking barriers, the national treatment provisions ensure that Canadians will have such access as the United States domestic firms are allowed to diversify. Financial services is a field in which the United States will benefit from Canada's experience with deregulation, although the pace of change in the United States is slow.

## EDITOR'S NOTE

October 1989. Since this postscript was written, the Meech Lake accord has been brought into question, and controversy rather than a cooperative spirit appears to be developing.

# PART V
# CONTRACTING-OUT

# 10 Contracting-out in Britain: Achievements and Problems

**Keith Hartley**

## Introduction

Contracting-out is one element of the current Government's privatisation policy. It is concerned with the central or local government finance of services which could be supplied by private contractors. In principle, contracting-out can be applied to a vast range of public sector services traditionally undertaken 'in-house'. Predictably, contracting-out has resulted in considerable controversy reflecting the views of the various groups likely to gain or lose from the policy. The topic is dominated by emotion, myths, claims and counter-claims, many of which need to be critically assessed and confronted with the available evidence. There is no shortage of hypotheses which need testing. This chapter reviews some of the major theoretical, empirical and policy issues in the debate. Competitive tendering also offers an opportunity to compare the efficiency of the private and public sectors in a situation where both sectors are competing for a given level of service.

Contracting-out is presented as part of procurement policy and it is placed in the context of UK privatisation policy.[1] In order to assess the current contracting-out initiatives, some policy rules for competitive tendering are outlined. The policy problem is then described, after which the arguments for and against competitive tendering are presented and appraised. Evidence can resolve some of the claims and counter-claims. Finally, consideration is given to the problems and limitations of contracting-out policy.

## Contracting-out, Procurement and Privatisation

Potentially, contracting-out is a vast area covering the possible use of private contractors for a whole range of public sector services. Currently, it is the focus of major policy initiatives in local government, the National Health Service (NHS), defence and other parts of central government. Cleaning, catering, laundry, refuse collection, maintenance and security services are popular examples. Some actual and potential examples are shown below. With its emphasis on better value for money, Government policy aims to extend the use of private contractors by public bodies where this will increase their 'economy, efficiency and effectiveness'.[2]

## Examples of Contracting-Out: Progress and Potential

*Local Authorities*

i. Current examples include refuse collection, catering and cleaning of offices, schools and streets.
ii. Since legislation in 1980, direct labour organisations (DLOs) are required to compete with private firms for most of their construction and maintenance work. DLOs became separate and accountable trading bodies required to earn a reasonable return on capital.
iii. The 1988 Local Government Act extended compulsory tendering to refuse collection, catering, cleaning streets and buildings, the maintenance of grounds and vehicles and the management of local authority sports and leisure facilities.
iv. In principle, other possibilities for contracting-out might include accountancy and architectural services, careers advice, computer and data processing services, housing valuation and sales, fire protection, and social welfare services such as child care.

*National Health Service*

i. A major DHSS policy initiative announced in 1983 introduced competitive tendering for NHS hospital catering, cleaning and laundry services (i.e. domestic services).
ii. In principle, other possibilities could include ambulance and transport services, portering, nursing services, the contracting-out of major surgery and patient care to private hospitals, together with hospital management, and care for elderly, disabled and mentally handicapped.

*Ministry of Defence*

i. Current examples include catering, cleaning and ground maintenance at defence establishments, the re-fitting of warships (traditionally undertaken in the Royal Dockyards), some limited aircraft services and vehicles repair, air transport, the management of stores, ferry services, ward auxiliaries and security guarding.
ii. In principle, other possibilities might include air traffic control, the maintenance and repair of vehicles and weapons and the training activities of the Armed Forces such as training of drivers, musicians, pilots and technicians, together with search and rescue operations (e.g. RAF v. Bristow Helicopters).

*Other Government Departments*

Examples include civil service catering; domestic, catering, security and cleaning services in the Home Office together with prison escort services; security services in the Treasury; cleaning and catering in the Inland Revenue; cleaning in DHSS; vehicle wheelclamping and the removal and storage of illegally parked vehicles, together with vehicle servicing and repair in the Metropolitan Police.

Contracting-out can be viewed as an aspect of public procurement policy: it involves the public sector purchasing goods and services from private firms. This means that public buyers (e.g. local authorities and hospitals) have to make three sets of procurement choices:

i. What to buy: a product or a service has to be specified and a contract has to be written, none of which is costless. For some services, such as cleaning, problems can arise in specifying the required standards in a contract: hence contracts might specify inputs rather than outputs. Such problems are not unique to contracting-out since in-house units have to be given job specifications.
ii. Who to buy it from: a contractor has to be selected using open or selective competition or direct negotiation with a preferred supplier.
iii. How to buy it: the form of contract has to be determined, chosing between fixed price and cost-plus contracts or some type of intermediate incentive arrangement; and the duration of contracts and the frequency of re-contracting have to be determined, together with the arrangements for policing and enforcing the contract (i.e. regulation).

Viewed as an aspect of public procurement, the debate about contracting-out is not new. Within defence and the NHS, for example, there is a long

tradition of buying defence equipment, pharmaceutical products, high technology medical equipment and buildings from private firms. In some cases, such as pharmaceutical products and non-competitive defence contracts, there are UK government controls on profitability.

The terms contracting-out, contractorisation, privatisation and competitive tendering are sometimes used interchangeably although they are not necessarily identical. A distinction needs to be made between ownership and competition. A public service could be privatised or contracted-out by transferring it to a private contractor without any competition. Indeed, the term privatisation has been the victim of varying definitions embracing de-regulation, liberalisation, vouchers, charging for public services previously provided at zero price and the transfer of assets (sales) from the state to the private sector. The distinction between government and private finance and provision can be used to classify the different forms of UK privatisation policy. Such a classification framework is shown in Table 1 which provides a starting point for analysis and also allows the rival advocates of finance and provision to debate various movements between the boxes! Obviously, some organisations cannot be confined to one box. British Coal and British Rail have received state subsidies, whilst there are privately-owned hospitals and schools. Nor does the classification distinguish between the different types of asset sales to the private sector. Some public organisations have been sold directly either to another company (e.g. British Aerospace acquisition of Rover) or to its managers and employees (e.g. National Freight). Finally, where monopolies have been transferred from the public to the private sector, specialist regulatory agencies have been created (e.g. telecommunications and gas).

Current UK privatisation policy has been associated with various objectives some of which are in conflict. Claims are made that consumers will benefit from rivalry, more choice, greater efficiency and innovation. The policy is also aimed at reducing the size of the public sector through denationalisation, and reduced public sector borrowing. It has been associated with a desire for wider share ownership and suggestions have been made that the real aim is to reduce the monopoly power of trade unions.[3] Conflicts arise between some of these objectives. For example, reducing the size of the public sector and maximising Treasury income from selling state assets can be achieved by transferring monopoly power from the public to the private sector without increasing rivalry which benefits consumers. Of course, it is likely that the actual extent and form of privatisation policy will reflect the influence of agents in the political market place, namely, governments seeking votes and established interest groups such as managers trying to protect their positions, especially their income and on-the-job leisure.

The controversy over privatisation raises the general question of whether

ownership is an important determinant of enterprise performance and efficiency. The current Government has claimed that privatisation has resulted in higher productivity and profitability (e.g. British Aerospace, Jaguar, National Freight Consortium). The official explanation offered is that:

> the overwhelming majority of employees have been shareholders in the newly privatised companies. They want their companies to succeed. Their companies have been released from the detailed controls of Whitehall and given more freedom to manager their own affairs. And they have been exposed to the full commercial disciplines of the customer. Even former monopolies now face increased competition.[4]

**Table 1: A Classification Scheme**

| PROVISION \ FINANCE | Public (state) | Private |
|---|---|---|
| Public (state) | Defence<br>Education<br>Health<br>Roads<br>Prisons | British Coal<br>British Rail<br>Electricity<br>Water |
| Private | Contracting-out and competitive tendering e.g. health and local authority services; also competition for subsidised bus services; vouchers | British Airports Authority<br>British Airways<br>British Gas<br>British Steel<br>British Telecom<br>Jaguar<br>National Freight Consortium<br>Rover Group<br>Sealink (ferries)<br>De-regulation of bus services<br>Local authority housing |

This official view suggests a model in which improvements in enterprise performance depend not only on ownership, but also on competition and managerial freedom. Some analysts would add the external environment as another variable in the model. Here, possibilities include the Thatcher effect via Rayner scrutinies, Financial Management Initiatives (FMIs), reduced personal taxation, the enterprise culture, and the withdrawal of subsidies providing a 'shock effect' throughout the public and private sectors.[5] Some of these complex and inter-dependent issues can be simplified into a two variable model showing the effects of ownership and market structure on efficiency. Table 2 shows a framework and suggests the following hypotheses on enterprise performance and efficiency.

i. D is superior A, where D represents private ownership and a competitive product market.
ii. D is equal to, or superior to, B : does ownership matter? One review of the evidence suggests that under competition, private firms are likely to be superior.[6]
iv. B is superior to A, reflecting the role of competition.
v. C is superior to A, reflecting the policing role of private capital markets.

**Table 2 : Ownership and Market Structure**

| | MARKETS | |
|---|---|---|
| **OWNERSHIP** | **Monopoly** | **Competitive** |
| **Public** | A | B |
| **Private** | C | D |

If the Government is serious about improving efficiency through contracting-out, then it needs to apply some simple policy rules. Departures from these rules suggest the pursuit of other objectives and/or the influence of interest groups such as bureaucracies, producers and unions on the formulation and implementation of efficiency-improving policies (reflecting vote-maximisation by governments?).

## Rules for a Competitive Tendering Policy

The Government has committed itself to contracting-out where possible. What does it have to do to ensure that its objectives are met? At the outset, it has to be recognised that if the Government wishes to improve efficiency, then contracting-out is not sufficient: genuine competition is required.

This suggests some rules for a competitive tendering policy designed to improve efficiency:

i. Genuine rivalry requires opportunities for new firms to enter the market. Otherwise, there is a danger that cartels and collusive arrangements will emerge resulting in private monopolies replacing public monopolies.
ii. Rivalry is needed for both a given and alternative levels of service. Genuine efficiency improvements require competitive tendering for different amounts and qualities of service so that the public buyer can determine whether the existing provision is worthwhile, or whether a higher or lower level would be more beneficial.
iii. Contracts should be awarded to the lowest bidder in the competition. Successful bidders should be awarded a fixed price contract with penalty clauses for private firms and their equivalent for in-house units. Without fixed price contracts and budget constraints, private firms and in-house units have every incentive to 'buy into' a contract by offering optimistic estimates of price, quality and delivery. To avoid optimistic estimates the public procurement agents need competitively-determined fixed price contracts and a willingness to enforce penalty clauses for poor quality and late delivery. In principle, in-house units which are successful in a competition need to be subject to the same penalties and incentives offered to private contractors.
iv. Details of the winning and rival bids in the competition should be published so that ratepayers and tax-payers know how their money is being spent. Publication also reduces the danger of political patronage in the award of contracts and the information contributes to the competitive process: winners and losers need to know how they compare.

These rules provide criteria for assessing existing policy on contracting-out. Consideration now needs to be given to the basic policy problem.

## The Policy Problem

How can public agencies such as local authorities and NHS hospitals assess the efficiency of their direct labour departments and in-house services? Direct labour departments are usually monopoly suppliers of services protected from possible public and private sector rivals. There is no competition in the sense that other departments within, say, the local authority or a hospital do not normally compete for the provision of specific services; nor is there any competition from other local authorities or from hospitals in different regions; and, until recently, private contractors were not allowed to tender for services. Consider some of the opportunities for competition. Why not encourage the

local authority passenger transport and fire departments to bid at regular intervals for the refuse collection service or for hospital ambulance and transport services; why not invite neighbouring local authorities and the nationalised industries to bid for transport services (e.g. passenger transport could be supplied by the Post Office as part of its mail service)? Take the example of ambulances. Competition might show convincingly that there are much cheaper and almost equally effective solutions to transporting patients rapidly to hospital. Why, for example, does the NHS need expensive, purpose-built ambulances; why not use conventional estate cars (cf. France)? Similarly, for defence, why use expensive, purpose-built aircraft carriers when we can quickly and cheaply convert surplus oil tankers into cheap aircraft carriers?

Admittedly within the public sector, departments compete with each other for limited budgets and there exist useful tools for improving efficiency such as programme budgeting, management by objectives, cash limits, efficiency audits, Rayner scrutinies, FMIs, and budget cuts. Nonetheless, there is scope for collusion rather than competition between departments (e.g. the principle of Buggins Turn); departments have every incentive to conceal valuable information on their efficiency from the public managers who control budgets; and the costs of any inefficiency can always be shifted to national and local taxpayers.

In the absence of competition from rival departments and from private contractors, there are no alternative sources of information and no alternative cost yardsticks to assess the efficiency of a public agency. Here, efficiency is defined to embrace two aspects:

i. It is concerned with the lowest-cost of supplying a *given* quantity and quality of service.
ii. It is also concerned with the lowest-cost of supplying *different* amounts and qualities of service. This aspect of efficiency enables a public agency to determine whether its existing level of service is 'worthwhile'. A lower level of service, either a reduced quantity or a lower quality, might be so much cheaper that the extra cost of the existing provision is discovered not to be worthwhile. Alternatively, competitive tendering for different levels of service might show that the benefits of a slightly higher level exceed its additional costs.

The question of undertaking work in-house or using outside suppliers is not unique to the public sector. Profit-seeking private firms will choose between the alternatives on the basis of their expected costs and benefits, including riskiness, and ultimately, their likely contribution to profitability. In competitive markets, the optimal amount of in-house services and outside

suppliers will reflect the efforts of private firms to economise on transaction costs.[7] However, compared with the public sector, private firms in competitive markets are subject to risks and uncertainty and they do not have exclusive legal property rights in specific services (e.g. hospital cleaning). On this basis, the policy problem leading to contracting-out can be viewed broadly as a public buyer (principal) – potential contractors (agent) relationship involving transactions costs, property rights and the opportunity for creating contestable markets by changing traditional property rights. Alternatively, contracting-out can be viewed as a study in rent-seeking with in-house units aiming to protect their rents (producer surplus) and private contractors pursuing monopoly rents. These concepts lie behind some of the arguments used by supporters and opponents of contracting-out.

## The Arguments For and Against

Contracting-out is offered as a solution to the problem of public sector monopolies which are reputed to be characterised by restrictive labour practices and low productivity, leading to inefficiency with its effects on local rates, taxes and government expenditure. Public sector in-house monopolies are criticised as inefficient bureaucracies responding to the wishes of producer groups rather than consumers. Contracting-out introduces competition into the provision of in-house public services.

To its supporters, competitive tendering or even the threat of rivalry means improved efficiency and cost savings. It is claimed to offer 'better value for money' by allowing public procurement agents to re-contract with different suppliers and for different levels of service. Competition between rival suppliers leads to the introduction of new ideas, the latest management techniques and modern equipment, so resulting in major changes in established and traditional methods of working. New equipment might replace labour; manning levels can be reassessed; and part-time workers might replace full-timers. Successful firms in a competition are also subject to the incentives and penalties of a fixed price contract so that there is no 'open-ended' financial commitment which can arise with in-house units. Furthermore, in the absence of competition, the in-house units and direct labour organisations might have been providing 'Rolls Royce' standards of service, regardless of costs. Examples include excessively high standards of cleanliness in public buildings and offices; the purchase of expensive high technology medical equipment which gives satisfaction to the users but makes no contribution to improving patient care or to reducing costs; local athletics tracks maintained at Olympic standards and municipal cricket pitches

maintained at Test Match standard! Competition for different levels of service allows a public agency to assess the costs and benefits of a little more or a little less so that it is better able to choose the most appropriate quantity and quality of service. However, this assumes that the public buyer is capable of representing the diverse interests and wishes of large numbers of individual consumers!

The opponents of contracting-out claim that it leads to a poor quality and unreliable service. Examples are given of dirty streets, schools and hospital wards and of penalty clauses imposed on contractors. In the NHS, private firms are accused of putting profits before people, so placing patients at risk. It is believed that caring for people cannot be subject to the profit motive: 'public need cannot be met by private greed'. Similarly, proposals for privately-managed prisons have been condemned because of fears of lower standards and conditions in prisons, with discipline determined by profit-conscious managers. Private contractors are also believed to be less reliable than in-house units. It is suggested that they are less able to respond to emergencies, they are liable to default and bankruptcy, and the award of a contract to a private firm creates industrial relations problems, including strikes. On cost savings, critics claim they are short-lived and based on phoney accounting. Low bids can be used to 'buy-into' an attractive new contract and eliminate the public sector in-house capacity so that the public authority loses its bargaining power. As a result, it becomes dependent on a private monopoly which, in the long-run, means higher prices, a lack of dynamism and a poor quality service.

Competitive tendering also involves transaction costs which are often ignored by the supporters of contracting-out. Specifying, monitoring and enforcing a contract for an outside firm is both costly and time-consuming. Moreover, critics claim that any cost savings from contracting-out are achieved at the expense of job losses, together with cuts in wages, hours of work and fringe benefits such as pensions, paid holidays and sick pay. In particular, it is suggested that these savings are achieved at the expense of the poorly paid members of society, so that contracting-out policy cannot avoid equity issues and debates about the distribution of income between labour and capital. Finally, opponents assert that private industry lacks the capacity to provide a *competitive* response to a major increase in demand for outside contracting by large parts of the public sector. The arguments for and against are summarised in Table 3.

**Table 3: The Arguments**

| The Case for Contracting-Out | The Case Against Contracting-Out |
|---|---|
| i. Public sector 'in-house' monopolies are inefficient bureaucracies satisfying the wishes of producer groups rather than consumers. | i. Private contractors offer a poor quality and unreliable service |
| ii. Public sector inefficiency is reflected in restrictive labour practices and low productivity with its effects on rates, taxes, subsidies and government expenditure | ii. Private contractors are liable to default, bankruptcy, and are less able to respond to emergencies |
| iii. There is an 'open-ended' financial commitment to public sector 'in-house' units | iii. In the NHS, private contractors put profits before people so placing patients at risk |
| iv. 'In-house' units seek to provide 'Rolls Royce' standards of service regardless of cost | iv. Awarding contracts to private firms leads to industrial relations problems and strikes |
| v. Competition allows regular re-contracting by public procurement agents | v. Contractors use low bids to 'buy into' attractive contracts and eliminate the 'in-house' capacity so that the public authority becomes dependent on a private monopoly |
| vi. Competition leads to new ideas, modern equipment and changes in traditional methods of working | vi. Competitive tendering is not costless: there are costs to the public authority in specifying, monitoring and enforcing contracts |
| vii. Successful firms in a competition are subject to the incentives and penalties of a fixed price contract | vii. Private contractors achieve cost savings by cutting jobs, reducing wages and worsening working conditions |
| viii. Contractors can be penalised for poor quality, delays and unreliability | viii. Private industry cannot provide a competitive response to a major increase in demand for outside contracting |
| ix. **The result is cost savings and 'better value for money'** | ix. **Result: Cost savings, if any, are short-lived and offset by reductions in the quality of services supplied** |

## The Need for Evidence

The arguments for and against provide extensive opportunities for critical analysis and evaluation. Some of the arguments obviously represent special pleading by those interest groups most likely to gain or lose from the policy. Private industry which is likely to gain will stress the benefits of 'free enterprise and competition'. In reality, businessmen have a remarkable propensity for seeking monopoly, entry barriers, tariff protection and government subsidies leading to on-the-job leisure and a quiet life. Similarly, contracting-out will be opposed by those trade unions and professional associations whose members are most likely to lose from the policy. They will eagerly report any examples of strikes, poor quality and poor performance due to private contractors, referring to a perfect model of the public sector in which such problems are never encountered!

Any evaluation needs to ensure that identical services are being compared (like with like). In the NHS, complaints have been made about the poor standard of cleaning provided by outside contractors; no mention is made of the standards of cleanliness provided by 'in-house' units where criticisms by hospital staff might be viewed as 'disloyal' and contrary to 'good working relationships'; nor is there any mention of the standards of cleanliness or health record of in-house NHS hospital kitchens. Similarly, proposals for privately-managed prisons are condemned because US experience shows that private prisons 'have not been problem free': this ignores the problems of public prisons (e.g. escapes, riots, rehabilitation records). Suggestions are also made that private contractors would acquire political influence and their interest would lie in having full prisons.[8] But such interests are not unique to the private sector: for example the Armed Forces are always demanding a larger defence budget, whilst teachers and lecturers have an obvious interest in larger school, college and university populations. In the public and private sectors, outcomes (output and its quality) will depend upon the structure of incentives and penalties which are given to agents.

Contracting-out need not be associated with lower quality. Contracts which specify service standards need to be written and enforced. In principle, this is similar to writing and enforcing the job specifications for an in-house unit. Moreover, society might prefer a lower quality. For example, it might not be willing to pay an extra 20 per cent in costs (e.g. less patient care) for a one per cent quality improvement.

Worries have also been expressed about the possible bankruptcy of private contractors, leading to the loss and disruption of services. In the NHS, for example, if a private contractor goes out of business, who cleans the wards tomorrow? There are at least three responses to this problem. First, it has to be recognised that there are no certainties: everything has a probability

attached to its outcome and these involve different costs. In-house units might guarantee a service so long as their costs are covered, regardless of their level. However, open-ended budgets (blank cheques) are costly and the price of avoiding, say, a small chance of bankruptcy might be less patient care. Second, even in-house units are subject to strikes so that they cannot guarantee service delivery. Third, if a private firm ceases trading, the public buyer has a number of options. A temporary delay and disruption might be accepted until a new contractor is selected; or a private firm might be brought in for a specific emergency; or the public agency could hire labour from the bankrupt contractor and from the market to undertake the service in-house.

Participants in the debate about contracting-out need to state whether they are comparing two 'ideal' models of the economy, namely perfect competition and perfect socialism; or whether they are comparing one of these ideal states with actual institutions; or whether they are comparing two imperfect but real world organisational arrangements. Moreover, any assessment of contracting-out and in-house provision requires the specification of some criteria for evaluation. What are the aims of public policy? Is the NHS, for example, concerned with patient care or with protecting jobs and solving Britain's unemployment and poverty problems? Any such evaluation cannot ignore the need for evidence. Indeed, many of the arguments for and against contracting-out can be resolved by empirical testing.

On the central question of the magnitude of cost savings from contracting-out, the available evidence is limited, often based on US experience and is frequently flawed in that it fails to compare like with like, it reflects political bias and is usually based on casual empiricism. Some UK examples of the cost savings due to contracting-out and competitive tendering are:

i. Savings of some 20 per cent on refuse collection by private contractors, after allowing for redundancy payments. However, evidence shows that competitive tendering for refuse collection results in cost savings of almost 20 per cent even where the service continues to be provided by the in-house unit. This suggests that competition is the crucial determinant of lower costs.[9].
ii. In Wandsworth, London, an extensive programme of competitive tendering and privatisation is estimated to have achieved savings of 28 per cent over a 5 year period.[10]
iii. The trade association for contract cleaners believes that in general at least 20 per cent can be saved from contracting-out whilst maintaining the same or even higher standards.
iv. In the NHS, competitive tendering for support services was estimated to have achieved annual savings exceeding £100m with almost 75 per cent of contracts awarded to in-house organisations (1988 prices).[11] Other estimates have shown typical annual cost savings of 20 per cent

from competition for NHS support services with one study suggesting a lower figure of 10 per cent annual savings on domestic services.[12]

v. In defence, contracting-out has resulted in net annual savings of about £50m.[13] Elsewhere in defence, MoD has claimed that the introduction of competition in equipment procurement has resulted in average cost savings of over 30 per cent.[14]

vi. A questionnaire survey of local authorities and the NHS estimated annual cost savings from competitive tendering of 26 per cent for the same level of service.[15]

Unfortunately, some of these studies are based on expected rather than realised cost savings; different methods are used to calculate cost savings; some studies do not make it clear whether they are holding constant the standard of service; others are based on the claims of contractors who have an interest in the policy. There is, though, a growing volume of evidence showing that competitive tendering results in substantial cost savings, with estimates usually ranging from 20 per cent to 30 per cent.[16] Nonetheless, this is an important and expanding policy area which is relatively under-researched. The field provides opportunities for analysing and measuring the role of competition and ownership in improving performance in the delivery of public services. After numerous UK examples of competitive tendering and contracting-out, there is a surprising lack of published information on the results of the policy, namely, its successes, its failures and its potential. Questions arise about how the policy has been implemented and how well it has been working. A research agenda is needed to determine what we know, what we do not know and what we need to know for informed public choices on competitive tendering policy.

## A Research Agenda

The various arguments for and against competitive tendering and contracting-out need to be formulated into testable hypotheses. Indeed, the field offers an opportunity to analyse and measure the role of competition and ownership in improving performance in the delivery of public services. Four issues are central to any economic evaluation, namely, the organisation of competitions, the effects on efficiency, the measurement of performance and the limitations of current policy, including the barriers to change.

Consider some of the questions which need answering for a systematic appraisal of competitive tendering and contracting out:

i. Are there any limits to contracting-out? Which services have been contracted-out? Are there any which cannot be contracted-out: if so,

which are these and why can they not be contracted-out? Here, there are opportunities for applying transaction cost and public choice models.

ii. Is tendering competitive and how are competitions organised? For example, how many firms bid; are both in-house units and private firms allowed to bid for contracts; and are competitions open or selective? Have in-house units been successful in competitions and have they been given contracts with incentives and penalty clauses? Do public authorities always award contracts to the lowest bidder? And what is a typical contract in terms of value, duration, pricing arrangements and penalty clauses?

iii. Are competitions for a given level and standard of service (technical efficiency) or different levels and standards of service (allocative efficiency)?

iv. Does competitive tendering result in cost savings? If so, how large are such savings and why do they arise? For example, are the savings due to lower employment, changes in the factor mix, lower rates of pay or superior organisation; and how do in-house units respond to rivalry? What happens to staff who lose their jobs: are they re-employed by private contractors?

v. Performance and regulation. How is performance measured and can outside contractors provide the same standard of service as in-house units? What has happened to quality: for example, are penalty clauses imposed for (a) private contractors and (b) in-house units? Are penalties based on complaints from the general public or on a professional appraisal of the services?

vi. Competitive tendering and contracting-out involves major managerial changes for the procurement agents (e.g. NHS, local authorities). Are managers given incentives to behave efficiently: for example, what has happened to their employment contracts?

vii. What are the transaction costs of organising competitions and negotiating, writing, policing and enforcing contracts? Such a question also needs to allow for the transaction costs involved in monitoring the in-house unit prior to the competitive tendering regime.

viii. What are the barriers to change and which groups oppose the policy?

In analysing these questions, there are extensive opportunities for applying economic models of bureaucracy, public choice, contestable markets, transaction cost economics and firms under regulatory constraints. The effects of competition on enterprise performance might be isolated by estimating the impact on the efficiency of the in-house unit (public ownership) following the introduction of rivalry. The ownership effect might be estimated by examining the cost savings when private firms are successful in

competition with in-house units (i.e. after adjusting or normalising for the competition effect). Research in this area also needs to embrace accountancy skills to investigate the appropriate means of incorporating overhead and capital costs into pricing, particularly where capital costs are already sunk.

The research is likely to involve interviews, postal questionnaires and econometric analysis of the data available from both private contractors and public authorities. A structured interview-questionnaire approach to a sample of public agencies is needed to promote insights into how the policy is working and to obtain data on contracts, on any cost savings and on quality problems (e.g. for econometric analysis). In selecting a sample for interviews, it would be informative to include public authorities which both support and oppose competitive tendering. Here, a major contribution might be to identify the ways in which a 'hostile' authority can impede and delay the implementation of the policy and bias the competition between private contractors and in-house bidders. Clearly, those likely to lose from competitive tendering will oppose the policy.

## Gainers, Losers and Barriers to Change

Ultimately, acceptance or rejection of contracting-out policy will depend on society's view about its desirability. Who gains what, who loses and by how much, and can the potential gainers overcompensate the potential losers from the change? For example, the extent of inefficiency in the public sector will be reflected in the magnitude of job losses. Within the NHS, will efficiency gains result in improved patient care? Will any improvements be located within the hospital which increases the efficiency of its ancillary services or will patients in some other district or region benefit; or, will doctors gain through more funds to purchase expensive high technology equipment which benefits the users rather than patients? Equity and distribution of income issues cannot be ignored. If contracting-out is restricted to manual groups, savings might be achieved at the expense of the poorly paid members of society, whilst inefficiencies amongst professional groups such as administrators and doctors remain untouched.

The possibility of job losses and unemployment due to contracting-out cannot be ignored. Job losses are likely whenever competition is introduced into situations of monopoly and inefficiency, where consumers and taxpayers are having to pay for inefficiency: it is similar to the effects of foreign competition on the UK car, shipbuilding, steel and textile industries. Consider the example of contracting-out in the NHS. Arguments about any resulting job losses cannot ignore the following responses:

i. What are the aims of the NHS? Is it concerned with patient care or job protection: is it the purpose of the NHS to solve Britain's unemployment

and poverty problems or is the aim to care for patients (i.e. producing health days or quality adjusted life years)?

ii. There will be some off-setting indirect employment effects. For example, savings due to contracting-out might lead to more spending elsewhere in the NHS and this will create more jobs; there will also be more jobs (replacement) amongst private contractors. Alternatively, if we continue to pay for inefficient services, the costs are shifted to taxpayers and private firms and this will lead to job losses (e.g. via reduced spending elsewhere; and higher national and local taxes for private firms will adversely affect their competitiveness); and, of course, higher cost support services means less to spend on other aspects of patient care.

iii. Worries about public expenditure require a comparison of the Exchequer outlays on the continued and indefinite support for existing inefficiency jobs with the budget costs of worker unemployment so long as people remain unemployed. It does not follow that *all* those who lose their jobs from contracting-out will remain unemployed for the rest of their working lives: some might find jobs quickly depending on how well local labour markets are working.

Although a competitive tendering policy is attractive to economists, it will inevitably encounter opposition from established interest groups likely to lose from the policy. Opponents of the policy can impose delays by insisting upon discussions with all 'interested' parties; the timing of any change can be 'inappropriate'; administrative time might be unavailable to prepare the tender documents and to undertake the necessary comparative studies especially in an era of manpower cuts; and an authority might be reluctant to face a confrontation with the trade unions leading to major industrial relations problems. Furthermore, opponents of privatisation can insist upon onerous performance requirements and guarantees from private contractors; they can require detailed information from firms or allow too little time to prepare bids; and they can place a premium on retaining direct control of their own services. In the NHS, one authority responded to the Government's contracting-out initiative by adopting a 'cautious but positive approach' and giving thought 'to the possibility of experimenting with a cleaning contract for a small hospital unit'.[17]

## Limitations of Current Policy

If society wants improved efficiency, then privatisation and contracting-out are not sufficient: competition is also required. But if public buyers are to

extend competitive tendering, they need to examine more critically some of their existing procurement procedures. There are deficiencies in current policy. To meet the criteria for a genuinely competitive tendering policy action is required as follows:

i. **Opportunities must be provided for new entrants so creating contestable markets.** Safeguards are required against the potential danger of private cartels and collusive arrangements replacing public monopolies. New entry might be encouraged by greater use of open competitions and by ensuring that some bids are obtained from firms which are not members of an established trade association. Furthermore, regular re-contracting avoids monopoly problems by allowing competitions at regular intervals, say, every three years.

ii. **Competitions are needed for both a given and alternative levels and standards of service.** By stressing competitive tendering for a given specification only, current policy is failing to exploit all the opportunities for efficiency improvements. Both contractors and public procurement agents should be encouraged to provide and to seek information on the costs of a little more or a little less in both the quantity and quality of service.

iii. **Contractors and in-house units must be allowed to compete on similar terms, so avoiding any bias between private and direct labour bidders** (i.e. the requirement for a level playing field). For example, in-house units might have access to valuable information about the service and they might not be required to lodge performance bonds. In-house units should not be allowed to see all tenders before submitting their bid. Also, the bidding requirements must be identical between contractors and direct labour organisations; and costly bidding requirements with a low probability of success will not create contestable markets. Equally, requirements cannot be ignored which penalise in-house units such as the need to earn a specified rate of return or restrictions on bidding for private contracts. The principles designed to create a level playing field are clear, but implementation and enforcement are not without their problems.

iv. **In-house units winning a competition need to be subject to the same incentives and penalties offered to private contractors.** There are no efficiency incentives for the in-house unit if all the savings from contracting-out accrue to the local or national treasury. Without efficiency incentives, individuals and groups have every incentive to spend rather than to economise. This requires efficiency incentives to be introduced into employment contracts in the public sector. One possibility would be to allow in-house units to operate as worker co-operatives, sharing in savings and bearing the

consequences of overruns. Admittedly, such a proposal is fraught with difficulties! In principle, then, in-house units need to be subject to a fixed budget equivalent to a fixed price contract and to be penalised for poor quality. Failure to recognise this problem could lead to the in-house units bidding low to eliminate rivals and then seeking a larger budget later.

v. **Public authorities should publish the results of the tendering process,** showing the number of bidders, the range of bids and the value of the contract awarded.

vi. **Penalty clauses must be enforced.** Where fixed price contracts are awarded public buyers must be prepared to enforce penalty clauses for late delivery and poor quality – otherwise, contractors faced with tight budgets have an incentive to respond with poor performance on other aspects of the contract. Of course, it might be difficult to enforce penalty clauses for direct labour organisations which are seen as part of the same group who are required to report upon and fine them.

vii. **Contracting-out policy should be subject to the current UK legislation on monopolies, mergers and restrictive practices.** The behaviour of public sector authorities, the performance of in-house units, the extent of competition for contracts and the award of contracts should be open to investigation by the Office of Fair Trading and its regulatory agencies. It is not at all obvious that special discretionary powers need to be given to an individual Secretary of State allowing actions to be taken against authorities which frustrate the objective or the results of fair competition. Issues of anti-competitive actions by public authorities, including cases where contracts are not awarded to the lowest bidder, need to be treated as a general problem and not one confined to an individual Department such as Environment, Health or Defence: such problems should be subject to the established machinery of UK competition policy. If this policy is inadequate, then it needs to be revised to remove its deficiencies.

Competitive tendering is likely to be associated with contractors lobbying for public sector business and for entry barriers to protect their existing markets and profits. Bribery and corruption might occur as contractors seek 'inside' information and preferential positions. However, such behaviour is likely to exist in all economic systems as agents pursue their own self-interest. Moreover, whilst bribery and corruption are costly to eliminate, they can be reduced through a competitive tendering policy which encourages new entrants, which publishes the results of tendering and which is subject to investigation by the Office of Fair Trading.

There remains a more fundamental worry. With competitive tendering, choices about the quantity and quality of service provision are ultimately made by elected representatives whose views are unlikely to reflect the diversity of preferences of large numbers of individual consumers in properly functioning markets. Consumers are only able to register their views about the volume and quality of service through complaints to officials or, ultimately, by voting at elections. The relevant consumer in competitive tendering is a proxy consumer, namely the political and administrative group vested with authority to devise tenders, award contracts and monitor outcomes. Obviously, the preferences and criteria of the political and administrative decision group are unlikely to coincide with those of the final consumers of public services. Whilst consumers may be indifferent between private and direct labour delivery arrangements except in terms of relative costs, this might not be true of the relevant decision-making groups.

## Conclusion

Competitive tendering and contracting-out policy offers extensive opportunities for experimentation throughout the public sector and for a proper evaluation of experience. Rivalry and contracting-out are not limited to such services as refuse collection and cleaning. In the NHS, for example, there are possibilities of contracting-out major surgery, the care of the elderly and disabled as well as nursing, transport and ambulance services, some of which might result from the proposals in the 1989 Government Review of the NHS. In defence, many of the activities undertaken by the Armed Forces could be supplied by private contractors although opponents usually refer to the 'overwhelming importance of operational factors' requiring services to be undertaken in-house. Examples include hospital services, transport pools, the training of skilled manpower (e.g. electricians, drivers, muscians, pilots), and the repair and maintenance of equipment and installations. However, if extensions of competition and contracting-out are confined to manual groups, savings might be achieved at the expense of lower-paid members of society whilst inefficiencies in public sector professional groups continue to exist (e.g. administrators, government scientists, doctors, officers in the Armed Forces). Professional groups will be extremely hostile to extensions of competitive tendering to their preserves with the extent of opposition probably indicating the magnitude of inefficiency. A series of properly conducted and evaluated experiments will demonstrate the potential for extensions of competitive tendering. After all if publicly-provided services are so superior, they will win any competition.

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# 11 Purchase of Service Contracting in the Social Services in Canada

**Suzanne Veit**

## Introduction

In Canada, the major responsibility for the provision of social services rests with the ten provincial governments. Diverse economies, social traditions and political ideologies at that level – conservative, social credit, liberal, new democratic – have shaped social service delivery patterns in quite different ways across the country. While there are some characteristics that are common to all provincial social service delivery systems, there are many more aspects that are unique to each system.

Purchase of service contracting (POSC) is one component of provincial social service systems that is not conceptualised, defined or implemented consistently across the country. In fact, the value of lack thereof of POSC is a topic that continues to generate a great deal of debate and discussion in social policy journals, among practitioners, politicians and client advocacy groups. The concept is tied to that of privatisation and, as such, raises all the important ideological questions concerning the proper role of government, the future of the voluntary sector and the always contentious issue of profit vs. non profit contractors.

In this chapter, I propose to define in some detail the specific characteristics of purchase of service contracts in the social services. I will outline the British Columbia experience in terms of rationale, scope and implementation

of purchase of service contracting, and I will review that experience against trends in other provincial jurisdictions. Finally, I will address what I believe to be the major issues associated with successful purchase of service contracts in the social services.

I am an official with the Ministry of Social Services and Housing of the Government of British Columbia. This Ministry established several years ago a policy to encourage the development of contracted services as an integral part of its overall social services delivery system. Our experience to date is that purchase of service contracting can be an effective and efficient service delivery option when it is supported by appropriate policies and procedures. As a result of this direct and ongoing experience, I do not approach the topic from the point of view of a detached and scholarly review of the concept – much as I recognise the value of that perspective. Rather, I operate within a system that is committed to this approach and has acted upon this commitment. Part of my responsibility is to participate in the development of management directions and decisions that will ensure the successful implementation of POSC.

## The Context

Purchase of service contracting in the social services has been described as:

> A legally binding agreement between a government contracting agency (with responsibility for serving clients and the resources to serve them) and a contractor (with appropriate service delivery capability) in which the contractor provides care of services to clients of the government contracting agency in exchange for funds or other resources. [1]

The potential scope of POSC is enormous and might include such diverse services as: income assistance administration; child protection; homes and services to mentally handicapped individuals; day care including special needs day care; single persons hostels; achievement centres; and homemakers.

In Canada, the general interest in POSC has been heightened in recent years by a number of important trends in the social services field. Perhaps the most influential from a social policy perspective has been the joint focus on community care (or deinstitutionalisation) and decentralisation. Community care refers to the shift away from institutions for persons with handicaps to the community. The development of community based services is required to implement deinstitutionalisation. The interest in moving away from large facilities to small, more home-like environments has been seen as quite compatible with the purchase of service contracting model. At the same time the renewed, widespread interest of many provincial governments to

decentralise their operations and become more community and region specific has also provided impetus to POSC.

The third major factor that helps to explain the growth of POSC in Canada is government 'downsizing': the response of government to what is perceived as a strong public dislike of bureaucracy along with a belief in the overload of government. [2]

Together, these three public sector trends – downsizing, decentralisation and deinstitutionalisation – are the key background forces that have shaped the current profile of POSC within the social service delivery system in Canada.

## The British Columbia Experience

In British Columbia in 1983-84, the Ministry of Human Resources (now called Social Services and Housing) spent $112 million on contracted services. In 1986-87, that figure rose to $170 million of a 1.4 billion dollar budget. Clearly, POSC is an important and growing economic reality as well as a social policy reality in British Columbia. [3]

Our experience to date is that POSC can be an effective service delivery mechanism if it is supported by a set of clear objectives, underlying principles, straightforward procedures, regular monitoring and evaluation. As with other areas of programme development, the establishment and maintenance of an appropriate framework requires a significant Ministry commitment, particularly at the initial stages. I would like to describe to you the framework that has evolved over the past few years within the Ministry of Social Services and Housing (MSSH) to support the purchase of services for Ministry clients.

### *Delivery System*

MSSH has three major goals:

A. To provide financial assistance to eligible individuals and, wherever possible, to assist these persons to retain or regain financial independence.
B. To investigate complaints and to protect children suffering from neglect and abuse in a manner , wherever possible, which maintains or restores the integrity of the family.
C. To provide for and/or support services which assist mentally handicapped individuals to achieve maximum independence and participate as full members of their communities. Over 70 programmes are in place to meet these goals. A staff of approximately 4,400 people work for MSSH.

The Ministry delivers social services by way of a combination of direct services provided by Ministry staff and services purchased from agencies and individuals not employed by the Ministry. In either case the Ministry retains responsibility for meeting its legislated mandate.

The Ministry is a decentralised organisation which operates some 160 district offices throughout the Province grouped into 17 regional districts. Each Regional Director is responsible for managing the full range of programmes and services offered by the Ministry in his or her region. This responsibility includes the negotiation and management of purchase of service contracts. Consequently, a large number of ministry staff are involved in managing purchase of services arrangements. In the larger centres (Vancouver, the Lower Mainland) teams of resource consultants have been formed to seek out and implement the POSC regional objectives, including the monitoring and evaluating of such contracts. From a corporate perspective, headquarters staff have assumed the responsibility for overall POSC policy direction, including the development of a POSC Policy and Procedures Manual, identification of staff training needs related to contract management and review of all legislation and related policies that impact on purchase of service contracts.

*Rationale for POSC*

The rationale for contracting in the Ministry of Social Services and Housing is threefold:

1. Services which are 'goal oriented' and/or 'time limited' can be bought when needed and in the amount needed and terminated when not required.
2. Contracting allows the ministry to tap the skills in a community, match them with service needs and get the job done free from the constraints of bureaucracy.
3 Contracting provides a cost efficient and accountable alternative to direct service.

Responsibility rests with ministry staff to ensure that all services, whether directly provided or purchased, fulfill the Ministry's mandate.

In exercising its statutory authority to purchase service, the Ministry has developed policies and procedures which are shaped by three guiding principles. These principles are:

1. Best Interests of the Client:
   The duties of the Minister and the Superintendent are always paramount and are not to be compromised by any contract.

2. Independent Contractual Relationships:
   The Ministry purchases services from independent contractors and seeks to maintain independent contractual relationships.
3. Contracting Accountability and in Good Faith:
   The Ministry ensures that fiscal accountability requirements are met and that contracts are negotiated in good faith. [4]

*Scope*

The scope of POSC has grown in British Columbia to include the following types of purchased services in the social services sector:

For children
- special care homes
- group homes
- bed subsidy homes
- specialised residential resources
- specialised non residential resources
- special services
- rehabilitation resources
- special needs day care
- infant development

For adults
- community projects
- residential services to mentally handicapped individuals
- self help skills
- job action
- hostels
- emergency shelters

In 1986-87, a total of 1,900 contracts valued at approximately $170 million dollars were entered into between the Ministry of Social Services and Housing and independent contractors. Thousands of individuals have been served and continue to be served by contractors to the Ministry.

Most of the service contracts administered by our Ministry are with non profit agencies, individuals or small proprietary businesses. They range from running day care centres specifically for multiply handicapped children to homes for three to four mentally handicapped adults who need some structure and support services to enable them to live in the community instead of in a larger institution. We have contractors working with income assistance recipients, helping them to acquire the skills necessary to move into the labour force. We have a large number of contracts with people prepared to take into

their homes children who have serious emotional difficulties and who are no longer in the care of their natural families.

*Accountability*

At a minimum, accountability involves the obligation to report in appropriate detail how the organisation is discharging its service and fiscal responsibilities so that evaluative and other decisions can be made.[5] In British Columbia, government accountability objectives have been listed in government Financial Administration Policy as follows:

- **probity** in the handling of government funds (ensuring that financial matters are handled in a proper and honest manner)
- **prudence** in the expending of government funds (being careful to avoid excessive expenditures and ensuring that funds are expended in a responsible manner)
- **legality** in the disbursement of government funds (ensuring that the governing statutory and regulatory provisions have been complied with and that no more has been spent for the purposes intended than has been approved by the Legislative Assembly)
- **economy** in the expending of government funds (requiring that resources be obtained in appropriate quality and quantity at the lowest cost)
- **efficiency** in the management of government programmes (producing the maximum output for any given set of resource inputs or, alternatively, requiring minimum inputs for any given quality and quantity of service provided)
- **effectiveness** in the delivery of government programmes (attempting to meet, to the degree possible, programme goals or other intended efforts). [6]

The Ministry employs liaison workers and resource consultants to develop the contract resources required to deliver services to individuals. These workers have been trained to ensure that the agreed services are delivered and that the contractor is fulfilling all the terms and conditions of the contract. The liaison workers are also responsible for ensuring that the Regional Director has sufficient information to answer any queries associated with the accountability objectives mentioned above.

*Policies and Procedures*

All staff responsible for purchased services are trained and provided with the Ministry's *Purchase of Service Contracting Manual.* That manual sets out

the key principles to be followed in purchasing services, the Ministry policy which guides all purchase of service agreements, the different procedures to be used at each stage of the purchase of service cycle and samples of all forms of contracts used in Ministry purchased services.

## Other Provincial Jurisdictions

POSC introduces a type of partnership between the public and private sectors that is relatively new and quite different from the more traditional, long-standing relationship between the non-profit sector and the public sector.

To my knowledge, the Government of British Columbia uses POSC more extensively than any other provincial government in Canada in its social service delivery system. I say this with some hesitation owing to the significant difficulties of comparing social service systems across the country. It would appear that while all provincial social service ministries engage in purchase of service contracting to some extent, the social policy environment within which it is practiced and, indeed, its very definition, vary widely from place to place.

In Quebec, the Ministry of Health and Social Services (budget $9 billion) administers a range of health and social services. For delivering social services, Quebec has opted for the establishment of a network of community service centres spread around the province. These community resource centres were established about 20 years ago by the provincial government. They are non-profit, quasi-governmental organisations. They provide the bulk of social services in the province, excluding income assistance which is administered by another ministry. In other words, the province of Quebec has taken a direct role in determining the structure of the private social service sector (non-profit), and operates via that structure. POSC is not a significant component of that system although some services such as foster homes are purchased. However, there are standardised fee structures for these types of purchased services which preclude any price variation or serious negotiation or competition among potential providers of service.

In Ontario, the Ministry of Community and Social Services spent $2.8 billion in 1985/86. Of that total, $1.2 billion was transferred to private sector agencies – known in Ontario as transfer payment agencies. The nature of the contractual relationship with the Ministry is determined by the following factors:

- most of the agencies are non-profit
- many of the larger agencies such as the Children's Aid Societies and the municipalities have the legal authority to deliver services of one kind or another

- the funds transferred to these agencies tend to be of the sustaining grant or core funding type
- there is no opportunity, generally, for the agency to profit financially from the contract and nor is there a risk of financial loss
- especially for the large agencies, contracts tend to be renewed almost automatically from year to year. There is no interest on the part of the Ministry to test the market and seek out a different service provider, perhaps at a better rate, with a different approach, and so on.

The current emphasis in Ontario seems to lie in the strengthening of the traditional partnership between the public and the non-profit sectors, through the enhancement of accountability systems that are more rigorous than those of the past.

Historically, the for-profit component of the private sector has had limited involvement in the delivery of social services. The existing partnership mode is seen as reflecting with some accuracy the prevailing values, tradition and sense of trust that have built up over time between the Ministry, the people of the province and the non-profit sector.

Manitoba and Nova Scotia social service delivery systems are similar to that of Ontario in the importance placed on the traditional partners of government – particularly the Children's Aid Societies – and the relative unimportance of POSC. For instance, in Nova Scotia, total expenditures of the Department of Social Services in 1986/87 were $292,500,000. Only 8 purchase of service contracts – valued at $705,905.00 – were entered into during that same period of time.

In Alberta and Saskatchewan, POSC is beginning to assume a more important profile. The Saskatchewan Social Services Ministry entered into 311 purchase of service contracts in 1986/87, valued at nearly $30 million. Total ministry expenditures of $361,417,000 were recorded for that fiscal year. As with British Columbia, the services most frequently contracted were for in-home and group homes for the mentally handicapped, and services to children in the care of the department.

The Alberta Ministry of Social Services spent a total of $1.148 billion in 1986/87, of which $102 million involved purchase of service contracts (a total of 360 contracts). Alberta and B.C. both have formal POSC policy manuals which establish procedures to ensure legal conformity and standardised usage of controls as well as guidelines to assist staff with contract management.

In Newfoundland and Labrador, the Department of Social Services expenditure for 1986/87 was $168,266 million, of which $11.123 million went to 91 purchase of service contracts. Almost all these contracts are with non-profit organisations – and are focussed on community-based services for the mentally handicapped, the disabled, young offenders and child welfare services.

New Brunswick gives sustaining grants as well as purchase of service contracts to about 160 agencies – but almost half do not have a formal contractual relationship with the Department of Health and Community Services.

In summary, it would seem fair to conclude that the nature of the relationship between the private and public sectors differs significantly from province to province. POSC represents one changing aspect of that relationship and, at the moment, is being explored most thoroughly by British Columbia, Alberta and Saskatchewan.

## A Review of Issues

Purchase of service contracting in the social services raises several interesting issues, concerns and possibilities. Some are essentially political and ideological issues and, as such, will always be a matter of opinion and belief. Others are more amenable to management and administrative policies. The major questions associated with POSC in my opinion can be summarised as follows:

### *1. A New Type of Partnership*

Provincial governments in Canada have always placed heavy reliance upon the provision of services by the non-government sector. In Ontario, for instance, the earliest law permitting the indenturing of orphaned and neglected children to private citizens (1779) and that creating the system of Children's Aid societies (1893) resulted in an early enduring partnership between governments and non-government sectors.[7]

Traditionally, this early form of partnership has been characterised by core funding or the 'grant-in-aid' form of resource allocation. Under this model, the non-governmental agency is given a grant or core funding every year to perform a service which is broadly defined, planned and implemented by the agency itself. Clients are agency clients – not clients of government. Workers are agency employees – not government employees. If legitimate costs to the agency exceed agreed budgets, it is possible for government to intervene and increase the allocation. If expenditures fall below budget allocations, unspent monies are returned to government or rolled into the agency's budget for the following year.

This type of public/private partnership still exists in many provinces. In British Columbia, however, the terms of the partnership are changing as a result of the importance of purchase of service contracting as a major source

of funding instead of core funding or grant-in-aid to the non government sector. This new type of partnership is quite different from the old one:

a. With POSC, agencies have legally binding contracts to perform services determined by government priorities
b. With POSC, the agency provides a service to clients who remain clients of government – but served by a contractor to government
c. Contract agency workers become direct providers of service, whereas government workers are either direct providers of service or contract managers more involved with contract negotiations, monitoring and evaluation.

By acting as agents of government, purchase of service contractor agencies acknowledge their link to government. In so doing, they appear to lose autonomy – the freedom of an organisation to make decisions with an optimal degree of discretion.[8] One could argue that organisational autonomy is elusive in all contexts and has always been relative and conditional for government and non-government agencies alike. Yet, it would also seem fair to acknowledge that an agency which has agreed to deliver a range of services on behalf of a government ministry in a manner that is consistent with ministry policies and priorities has less autonomy than an agency that benefits from core funding or grants from a ministry with fewer strings attached.

From the government perspective, some loss of non-government agency autonomy is the unavoidable outcome of a system that places a high value on accountability for monies spent by the private sector on behalf of government. Purchase of service contracts should reflect government priorities; they should be specific, focussed, and time-limited. They can be monitored, renewed or terminated with a greater sense of control by government over the nature of the service to be purchased than is traditionally possible under core-funding or grant-in-aid financing. Hence, POSC presents accountability benefits of a significant magnitude.

### 2. *Motivation of Contractor*

The private sector of social welfare has traditionally been made up almost exclusively of nonprofit organisations. This 'voluntary sector' is generally characterised by the absence of a profit motive and the dedication to furthering community and individual well-being rather than creating financial gain. The increasing importance of POSC as a form of funding has attracted proprietary agencies dedicated to service at a profit. This attraction is due to the fact that POSC allows for the possibility of making a profit as well as that of incurring a loss. These proprietary agencies have now penetrated the private sector of

social welfare and have created competition in some cases between profit and nonprofit agencies.

For many social service analysts, this trend has raised the basic question: Is there a place for profit making businesses in the provision of quality social services?

Many empirical studies have tried to determine the relative efficiencies and effectiveness of profit and nonprofit social service providers. The results to date are quite inconclusive.[9] In large part, the indecisive findings are a result of a lack of consensus on appropriate indicators for effectiveness, whether or not the service in question is protected by a profit or nonprofit agency.

For instance, if a counselling service of teenagers is being assessed, what would be reasonable indicators of success? Showing up for appointments? Not running away from home? Staying at school? And to what extent, for all of the above? Is the number of clients using the service considered a sufficient measurement? And over what period of time should beneficial aspects of the counselling be measured?

The central question that needs to be addressed is this: under what conditions is the financial motivation of the service provider a relevant consideration? Gilbert [10] has proposed four practical conditions that might bear on the choice between profit-making and the nonprofit providers of a given service. They are:

a. the nature of the service – whether standardised or custom tailored
b. the average client's degree of competence
c. the extent to which the service is invested with coercive powers
d. the scope and potency of the regulatory environments in which social service agencies operate.

To the extent a service is government regulated (like day care), standardised (like meals-on-wheels) and provided to individuals who can make their displeasure known if they are not satisfied with the service (like job readiness programmes), then the profit motive should not be a problem and might indeed be an asset in the provision of services. Where the service is personalised, complex, and flows from a coercive power, then nonprofits would possibly be more appropriate.

I would add one more consideration to Gilbert's four. In my opinion, the private sector of social welfare is really comprised of three major groups – nonprofit organisations, small propriety agencies, and traditional profit-making companies. To say that small proprietary agencies are interested in making a 'profit' through the provision of social services often seems to overstate the case.

Who are the proprietary agencies? Often they are owner/operator

individuals or couples who agree to take in one or two foster children, for example, and thereby make enough income to meet their expenses, save a little money and keep themselves financially solvent. In an era where government and voluntary sector jobs are scarce, the establishment of a proprietary agency becomes a creative job-development option. The owners usually draw the equivalent of a salary for a job they have created in the absence of other, more well-established work options. That it not to say that there is *no* profit ever to be made in the provision of social services. But, for those interested in big money, there are more lucrative sectors upon which to concentrate than the social services.

In the final analysis I believe government must be concerned primarily with meeting its legislated mandate in a cost-effective manner, providing services and programmes to assist clients as required. Agencies – whether they are profit or nonprofit – that can deliver such services should be considered for contracts.

### *3. Defining The Public Interest*

One measure against which POSC is often assessed is the extent to which it enhances or detracts from the public interest. There are several major groups whose interests diverge when it comes to POSC.

The first interest group is comprised of the clients. Whatever social service the client is entitled to must be delivered in the most timely and effective way possible. Client satisfaction surveys with social welfare services in general have presented great difficulties in interpretation:

> Whatever the reason, there is much evidence to suggest that despite the sophisticated statistical manipulations often accompanying client surveys, the translation of consumer satisfaction ratings into judgements of social welfare programme performance is an exercise of dubious validity.[11]

It would appear that the client cares less about who provides the services than about access to and quality of that service.

The second major interest group associated with POSC is the social work profession. The interests of this group relate in large part to their status as employees. Certainly it holds that social workers who are members of a collective bargaining unit would perceive that they have more long-term job security and a higher level of benefits than those social workers who are employees of agencies on contract to the ministry. In the latter case, job availability is tied to the life of the contract which may or may not be renewed. Hence, it is not surprising that social work (and other professional

groups such as nurses) union members and their representatives are cautious and somewhat concerned about the growing importance of POSC as a delivery option.

The third major interest group is the taxpayer. In recent years, this group has made its views known very clearly about meeting social welfare needs as cost-effectively as possible.

POSC allows programmes and services to be delivered in a manner that should capture the benefits of the market place by having competing contractors bid on purchase of service contracts. It is assumed that these services can be provided in a more cost-effective manner than those delivered by the often cumbersome and long-standing bureaucratic model. It should be noted, however, that there is no conclusive, impartial evidence that POSC is always more cost-effective than government delivered services. However, with the extensive monitoring of POSC services currently underway, it will soon be possible to document the belief that POSC is more cost-effective than direct government services, in most instances.

To the extent that POSC is an integral component of a social service delivery mechanism that contributes to the timely and accessible provision of social services to eligible clients in a cost-effective manner, then I would say that it serves the broad public interest despite the fact that, at the same time, it diminishes the power base of the public sector unions.

### 4. *The Matter of Accountability*

There are many facets to this issue, some of which have already been touched upon in other sections of this chapter. Some additional considerations might be taken into account.

When public money is given to private agencies there is always a question of how to develop systems and structures that will be able to establish how that money was actually spent. In an article on this issue, Langford [12] detailed the difficulties in British Columbia of tracking private expenditures of public money. Yet, the potential to meet government accountability objectives is significantly higher in the new partnership mode – POSC – than in the old partnership mode – grants and core funding. When a ministry purchases a social service, it behooves that ministry to identify the target group, what amount of service is to be purchased, what the service goals are, what the expected cost will be and how the service will be monitored. The contract documents are much more explicit than the typical letters of exchange formalising most grants or core funding. As a result, the next step in the accountability cycle, that is the process of monitoring and evaluation, is greatly simplified. I am not suggesting that POSC *ensures* accountability but rather that POSC lends itself to the achievement of accountability objectives because it establishes the terms and conditions of service and

financial remuneration in an explicit, formalised manner which can then be evaluated.

The issue of accountability is particularly crucial when POSC combines with decentralisation and deinstitutionalisation to serve the needs of handicapped people. For instance, five years ago in British Columbia any person interested in knowing what programmes and services were then available to multiply handicapped children could visit one of our resources such as Tranquille Institution, where they could talk to staff and see for themselves the environment within which these children live. On solid social policy grounds, a decision was subsequently made to return those children to the community and to give them the same opportunity to live in a home-like environment, as other children enjoy. Many children were placed in small group homes run by individuals and agencies under contract to the Ministry. If the same person who, five years ago, wanted to get first-hand information about services to multiply handicapped children were to come again to British Columbia with the same interest it would be considerably more difficult and more time consuming to touch base with these children. In a sense, they have become an invisible minority, far from the public eye. At the same time, their individual visibility at the community level has been enhanced. There is overwhelming evidence to support the process of normalisation and community-based services for these children.[13]

In this type of situation where the client group is comprised of individuals who cannot speak for themselves and who are served by contractors providing resources at the request of the Ministry, it is particularly essential for the Ministry to monitor, evaluate and report on the quality of service provided. The Ministry retains responsibility for these clients even if it chooses to purchase services for them from the private sector.

### 5. *Contract Management*

The single most important factor associated with meeting accountability objectives concerning POSC is the quality of the Ministry contract managers. To negotiate and write up the terms and conditions of the contract, to select the most suitable contractor, to monitor, evaluate, renew or terminate the contract and to ensure throughout the contracting cycle that the Ministry meets its mandate, specialised ministry staff are required. The critical point to remember when purchasing services is that POSC is simply a mechanism to allow the Ministry to meet its objectives as effectively and efficiently as possible. POSC is *not* an opportunity for the Ministry to divest itself of its legislated mandate. Throughout the contracting cycle, it is crucial for the Ministry to be in control of POSC, and to manage POSC around its own priorities and requirements. The balancing that is necessary, and one of the

challenges facing Ministry contract managers, is to set out the contract in such a way that clear, overall direction and specifications are established and, at the same time, to leave to the contractor the task of deciding 'how' these specifications can best be met, within the guidelines and regulations of the Ministry.

In most social service Ministries, key management positions are usually held by social workers. In their professional training and experience, social workers have not usually been exposed to contract management. They have been trained to deliver services, not to manage the delivery of services via third-party contractors. A quick perusal of courses offered by Canadian schools of social work will confirm the relative scarcity of material, information and background on social service contract management.

In the absence of already-trained contract managers with a background of social work, the Ministries wishing to pursue POSC must be prepared to initiate their own training programmes. Policies and procedures need to be developed, tested, implemented and formalised. Negotiation skills are essential. Financial analysis and assessment capabilities have to be learned. Some background in the area of contract law is useful.

One aspect of contract management training that is somewhat elusive yet of primary concern is ensuring that Ministry contract managers understand the practical implications of purchasing services from the private sector. In order to obtain services for members of the public at a cost effective price, it follows that a competitive market situation is optimum. The purchaser should be able to select, from among a number of potential providers, which agency or individual presents the most acceptable service at the most cost-effective price. Unfortunately, one common problem that seems to surface in different situations is that of the contract manager reviewing a contract for the next year who, faced with a heavy workload or other priorities, does not have the time or the inclination to ensure that the current supplier remains, in fact, the best one for the Ministry in terms of value for public dollars spent. Another, more difficult consideration that is certainly more characteristic of POSC in the social services than in other sectors, is the value placed on continuity, for the sake of the client, versus the value of change if a new supplier enters the market with a more attractive set of options from the point of view of purchasing power.

For instance, a young mentally handicapped adult may be living in a small group home owned and operated by a Ministry contractor. After three or four years, the Ministry may conclude that another contractor could provide the same service at a lower price. Yet, the client is happy in his first home, has established an important relationship with the owner/operator and has no interest in changing homes. The best interests of the client have to be given priority even if this may mean a less than complete reliance on purely market

considerations. In this case, the importance of an effective Ministry contract manager is highlighted once again.

Contracting is a delivery option, it is not a Ministry objective. The decision directly by Ministry employees, has always to take into account the extent to which either option helps the Ministry to meet its objectives in the most effective and efficient manner possible.

## Notes

1. Peter M. Kettner and Lawrence L. Martin, *Purchase of Service Contracting* (A Sage Human Services Guide 44, Sage Publications, 1987, p. 22).
2. Ralph M. Kramer, 'Contracting for Human Services: An Organisational Perspective,' *Social Policy Analysis*, p. 421.
3. The author would like to acknowledge the significant work of Valerie Mitchell, Senior Policy and Planning Analyst, Ministry of Social Services and Housing in the development of ministry documents summarising the evolving state of POSC within the Ministry. Much of the information contained in this section comes from material dating back to 1983-84 which was prepared by Ms. Mitchell. It is also noted that Mr. John Noble, Deputy Minister of the Ministry of Human Resources in the early-to-mid 80s, was instrumental in developing the Ministry's contracting policies.
4. From the *Purchase of Services Manual* (Ministry of Social Services and Housing, Government of British Columbia, 1987).
5. Ralph M. Kramer, Ibid., p. 428.
6. From *Financial Administration Policy* (Treasury Board, Government of British Columbia, 1987).
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# PART VI
# PROBLEMS AND PROSPECTS

# 12 Regulation of Privatised Firms in Britain

**John Vickers and George Yarrow**

## Introduction

Regulation was not a major issue in the initial phase of the British privatisation programme. The firms transferred to the private sector in Mrs. Thatcher's first five years in office – e.g., Britoil, British Aerospace, Cable & Wireless, Jaguar – all operated in more or less competitive conditions, and the question of how to constrain market power did not arise. But the Government's ambitions to sell state assets rapidly expanded. The privatisation of British Telecom (BT) in 1984 was the first in a sequence of sales of virtual monopolies, including British Gas (1986), the British Airports Authority (1987), the Water Authorities (1989), and parts of the electricity industry in the near future. Regulated private monopoly has come to be regarded by the Government as being superior to publicly owned monopoly. Whatever the merits of this view, it has brought regulatory policy into the spotlight. The aim of this chapter is briefly to assess two key aspects of the regulation of privatised firms with market power: the 'RPI-X' method of price control, and regulation to promote effective competition in industries where some liberalisation has occurred.[1]

## RPI-X Price Control

The most important element of regulation in the privatised telecommunications, gas, airports and water industries is the RPI-X method of price control, which will almost certainly be employed also in the electricity industry. In its basic form RPI-X requires an average of the prices charged by the regulated firm to fall by at least X per cent per annum in real terms. That is to say, the maximum permitted annual increase in average prices is the rate of inflation of the retail price index (RPI) minus X per cent.

On the face of it, the RPI-X method of *price* control would seem to have several advantages over methods of *rate-of-return* regulation familiar in the United States.[2] First, the regulatory burden appears to be limited to checking that price increases comply with the formula, and the danger of 'capture' is thereby reduced. Secondly, incentives for productive efficiency seem good insofar as the benefits from innovation and cost reduction are retained by the firm. Likewise, problems of inefficient strategic investment behaviour appear not to be a concern.

Table 1 shows some details of the operation of RPI-X regulation in the three instances so far: BT, British Gas and BAA. Price control applies to the parts of their businesses where competition is weakest. BT, British Gas and BAA nevertheless enjoy significant power in markets outside the scope of RPI-X control, and conversely, there is sometimes a degree of competition in regulated markets – e.g., Mercury competes for some of BT's long-distance business.

No attempts were made significantly to adjust either the level or the structure of prices when the three firms were privatised. Thus in general they continued the pricing regimes of their nationalised predecessors, and some allocative inefficiencies from the past have tended to persist. British Gas inherited the low cost gas supply contracts negotiated by its nationalised ancester in the 1960s, and its prices to domestic users are still based on its correspondingly low average costs of supply, rather than (the higher) marginal costs, which would give more accurate price signals. Similarly, many airport charges are too low, especially in peak times, due to cross-subsidies from BAA's commercial activities, which are boosted by tax concessions to duty free goods. BT also inherited an inefficient relative price structure, but it has been able to alter the situation (see below).

The choice of X in the price control formula is naturally thought of as the potential rate of improvement in cost efficiency for the regulated products and services. However, if there are increasing returns to scale, demand growth must also be taken into account. Movements along cost curves must be considered as well as shifts of cost curves.

Table 1: The operation of RPI-X regulation

| | British Telecom | British Gas | BAA (British Airports Authority) |
|---|---|---|---|
| (1) Regulated | Local and trunk calls, line rental. | Gas supplied to domestic users [more precisely, those using no more than 25K therms per annum]. | Airport charges (for departing passengers, aircraft landing etc.) at London airports (Heathrow, Gatwick and Stansted). |
| Unregulated | International calls, payphone calls, customers premises equipment, telex, mobile radio, VANS, etc. | Gas supplied to industrial and commercial users. Connection charges, appliance sales, etc. | Airport charges at Scottish airports. Commercial activities (e.g., retail). |
| (2) X = ?; base year prices | X=3; pre-existing price structure. | X=2; pre-existing price | X=1; pre-existing price structure |
| (3) Price index/average | The weights in the price index for year *t* are proportional to contributions to turnover in the previous year. | Average price per therm | Average revenue per passenger |
| (4) Scope for relative price changes within overall constraint. | BT has undertaken that RPI+2 will apply to domestic rental charges. Oftel has investigated rebalancing between local and trunk call charges, and has investigated some other individual prices. | The standing charge (i.e., the fixed element of the charge to the user) cannot increase by more than RPI in any year. | RPI-1 applies to airport charges at Heathrow and Gatwick individually, as well as to the group of airports. |
| (5) Adjustments for exogenous | None | Full adjustment is made for changes in the cost of gas supplies to British Gas. | Adjustment is made for 75 per cent of additional costs arising from Government airport security requirements. |
| (6) Timing of regulatory review. | After five years (i.e., after 1989) price control will operate by a licence modification either agreed with BT, or imposed on BT after an MMC recommendation on public interest grounds. | Price control will be reviewed after five years (in 1991) following an MMC investigation. | Price control will be reviewed after five years (in 1992) by the Civil Aviation Authority following an MMC investigation. |

The telecommunications industry is enjoying a high rate of technological progress, especially in long-distance services, and all three industries are experiencing demand growth, and have major scale economies in some regulated activities due to the presence of fixed costs – e.g., BT's local networks, the British Gas distribution infrastructure, and BAA's runways and terminals. In addition, since part of the rationale for privatisation was that cost inefficiencies existed under public ownership, X should initially reflect the scope for eliminating those inefficiencies. In terms of prospects for profit growth, these considerations together suggest that none of the three firms faces an onerous X.

It is clear from the table that, although there are some restrictions on individual prices within the regulated baskets, there is nevertheless considerable scope for firms to adjust relative prices within the overall constraint. BT has done just that: within two years of privatisation, peak time local call charges had risen by about 25 per cent, and some peak time call charges had fallen by 25 per cent. It is therefore important to ask whether RPI-X regulation creates good incentives for efficient relative pricing. The answer to this question depends upon the degree of competition faced by the regulated firm, but first we shall consider a multiproduct monopolist.

The monopolist's pricing behaviour depends on whether the weights in the regulated price index are exogenous or endogenous to the firm. If the weights $w_i$ that apply to regulated prices $p_i$ are fixed appropriately (a task requiring considerable information or luck) then Ramsey pricing can be induced. But if the weights are endogenous – e.g., proportion to turnover – the firm has an incentive to act strategically to influence them. Indeed, British Gas and BAA face constraints on average revenue per therm and per passenger respectively. This creates a tendency for them to expand low cost supplies, and to contract high cost supplies, relative to the Ramsey optimum. This in turn could have implications for investment planning. The weights in BT's price control formula are updated with a year's lag. Thus in the short term the weights are fixed, but they too could be manipulated strategically over time.

When actual or potential competition exists, there are further grounds for concern about relative pricing. For example, Oftel conducted a detailed enquiry into the 'rebalancing' of BT's tariffs (i.e. the raising of local call charges and lowering of long-distance charges), and concluded that the rebalancing in the 1985 and 1986 price changes was justified by costs, but that further increases in local call charges were probably not necessary. Oftel has reviewed other individual prices – some that come under the RPI-3 formula (e.g. rental charges, differentials relating to time of day, and discounts on some long-distance routes), and some 'unregulated' prices

(e.g. access lines, private leased lines, payphone rentals and telex services). In addition, Oftel has investigated the general level of BT's prices.

Oftel's formal powers to regulate individual prices are limited, but ultimately it can seek a modification of BT's licence from the MMC. The point to note, however, is that Oftel has chosen to be active in respect of numerous aspects of pricing behaviour, and has gone far beyond the simple remit that RPI-X lays down. Far from causing susceptibility to capture, Oftel's active use of its discretion is a clear sign that it has not been captured. A captured regulator would be one who did confine his activities to checking that the RPI-X formula was being obeyed.

RPI-X regulation seems to provide excellent incentives for cost efficiency, because, unlike with rate-of-return regulation, the firm gains the benefit of any cost savings that it achieves, at least in the short term. Is this advantage illusory or real? The answer to this question turns on the nature of regulatory review of pricing, and in particular the information available to the authorities, at the time of review. If the regulated firm has a virtual 'monopoly of information' about industry conditions, so that its own costs and profits form the basis for the revised price regime, then RPI-X can have very poor incentives for investment and cost efficiency. Incentives are reasonably good when regulatory review is some way off, but they can become quite perverse as the time of review draws near. For example, the firm's rate-of-return on capital in the year preceding review is likely to be a crucial piece of information in determining the maximum permitted prices for the succeeding *five* years. Depressing the rate-of-return in that year by raising costs and/or inflating the capital base could therefore pay very high dividends to the firm by securing more favourable prices for *several* years hence. In these circumstances the long (five year) regulatory lag might weaken incentives for inefficient strategic behaviour soon after review, but gives them added strength soon before review.

Since BT, British Gas and BAA have been sold with their monopoly positions essentially intact, there is little information for price review other than the costs and profits of the regulated firms. Oftel has already reviewed BT's prices and profits using rate-of-return data, which is perhaps a good guide to what will happen when five-year review does occur. Littlechild himself confirms the point when writing [3] that 'it should now be evident that rate of return considerations are necessarily implicit in setting and resetting X'.

The incentive problems will disappear only when the regulated firm's monopoly of information is broken. . The promotion of more effective competition would provide valuable information for regulation, as well as diminishing the need to regulate. The horizontal restructuring of the regulated firm – e.g. into geographic regions – would also enhance the

information available to regulators and might permit 'yardstick regulation' [4], depending on the degree of correlation between the uncertainties facing firms in different regions. Similarly, franchising – competition for the market – can be seen as a way of breaking the monopoly of information, although its use in major industries is limited by complexities of contract specification and administration.

Unless regulators have independent information about the scope for efficiency gains, there are few grounds for optimism about the incentive effects of RPI-X or any other system of price regulation.

## Regulation to promote competition

Privatisation in Britain has been accompanied by measures intended to introduce a degree of competition into some of the industries concerned. Liberalisation has not been carried as far as it might have been, but some statutory barriers to entry have been removed by legislation, including the 1981 British Telecommunications Act, the 1982 Oil and Gas (Enterprise) Act, the 1983 Energy Act, and the 1980 and 1985 Transport Acts. Liberalising measures such as these provide no guarantee that entrants will in practice be able to compete on fair terms, especially in view of the market power enjoyed by privatised incumbent firms, and an import function of the new regulatory authorities is to safeguard conditions of effective competition. Competition issues arising from the vertically integrated nature of major privatised companies are a particular focus of concern.

A common problem has to do with natural monopoly transmission systems. For example, BT has a monopoly over local telecom networks. Mercury cannot compete with BT in the long-distance market unless it can gain access ('interconnect') to BT's local networks, and the strength of its competitive challenge depends upon the terms of interconnection. Being vertically integrated BT has every incentive to thwart Mercury by denying access, or by permitting it only on unfavourable terms. Potential competitions to British Gas are in a similar position, because they rely on the incumbent firm's pipeline for distribution. (They also face other disadvantages, e.g. the low cost supplies available to British Gas under old contracts). Likewise, competitors in electricity generation need to use the transmission system of the Central Electricity Generating Board (CEGB).

Vertical separation is one way of seeking to combat this danger of anti-competitive behaviour. When the AT&T law suit ended in 1982, AT&T was required to divest itself of its local network operations, which were taken over by separate regional companies (the 'Baby Bells'). Being under separate ownership, the local network operators have less incentive to favour any particular long distance carrier. British telecommunications

policy has been quite different: BT was privatised as a vertically (and horizontally) integrated unit. Whereas vertical separation would have reduced *incentives* to distort competition, vertical integration requires effective *regulation* of conduct. Once again, the information available to the regulatory authorities is crucial, since it is impossible to guard against discriminatory or predatory behaviour without being able to detect its occurrence. The regulatory regime for British Gas is especially deficient in this regard, because the information available to Ofgas is woefully inadequate for effective regulation. For example, British Gas is not required to provide separate accounts for different parts of its gas supply business. In telecommunications, however, Oftel has actively sought accounting information about numerous aspects of BT's business.

Oftel's most important policy decision concerning market power in vertically related markets was the ruling on interconnection in October 1985. Oftel ruled that BT's and Mercury's networks must have full interconnection for both domestic and international calls. The ruling also determined the costs that Mercury must pay BT for interconnection. These are based on BT's costs, and as a result Mercury pays substantially less than BT's normal charges for the use of its lines. Oftel's ruling was a major precompetitive step which indicates the weight that the DGT has chosen to give to the objective of promoting effective competition. How competition between BT and Mercury actually will take shape, especially given the current ban on further entry, is another matter.

Competition in telecommunications apparatus is also influenced by BT's vertical integration.[5] Again in contrast with American policy, BT's vertical integration has been maintained and indeed extended since privatisation by its acquisition in 1986 of a majority interest in Mitel, the Canadian equipment manufacturer. The merger was allowed subject to conditions on BT. This decision reflects a high degree of optimism about the effectiveness of regulation in enforcing the conditions and coping with the dangers to competiton that the merger poses.

In this section we have dwelt on regulation to promote competition in telecommunications because BT is the only privatised firm that has now been regulated for several years. However, the privatisation of the massive electricity supply industry may be the most important test of policy towards market power in vertically related markets. Although current plans call, in the name of competition, for most of the Central Electricity Generating Board's power stations to be split between two successor companies, the associated proposal to transfer the ownership of the national high-voltage grid to area distribution companies will strengthen the market power of the distributors. The prospects for competition are also likely to be dimmed by the Government's commitment to nuclear power, which in current

conditions is a high cost method of generating electricity. It therefore remains to be seen whether or not the formidable problems surrounding the privatisation can be satisfactorily overcome.

## Notes

1. For more detailed accounts see:–
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# 13 Regulation, Deregulation, Competition and Privatisation: The Canadian Experience

**Andrew J. Roman**

## Introduction

Regulation is bad. Deregulation is good. Monopoly is bad. Competition is good. It's that simple. Or is it?

Regulation, deregulation, competition, privatisation – the very words evoke feelings of approval or disapproval in the listener. George Stigler, the US economist and Nobel laureate, has observed that 'Competition, like other forms of therapeutic hardship, is by wide and age-long consent, highly beneficial to society when imposed upon other people'.[1] Even those who are enamoured of competition often argue that their own industry ought to be the exception to the general rule.

One of the delicious ironies of the OPEC cartel's having driven up oil prices so dramatically in the early 1980's was the pirouette performed by the oil industry in Alberta, which owns most of Canada's marketable petroleum resources. While oil prices were rising, the new breed of 'blue-eyed sheiks' drove around Calgary in cars sporting bumper stickers reading 'Let the Eastern bastards freeze in the dark'. Their lawyers appeared at Federal hearings and their Provincial politicians at Federal-Provincial conferences demanding deregulation of oil prices. 'Let the forces of the marketplace prevail, and give us world prices', they would insist. They got their way. When the OPEC cartel collapsed, however, and much of Alberta found itself

overbuilt and overpriced, the economic advantage was reversed. As real estate prices plummeted, unemployment soared, banks, trust companies and wealthy individuals became insolvent, the oil industry and its supporters demanded an end to world pricing and sought greater state protection to 'preserve this essential industry'. Thus we see, in the span of a few years, Canada's most conservative province as the home of vigorous capitalists when oil prices were rising and, by their own definition, 'socialists' when oil prices were falling.

Was this inconsistent? Of course not. It was perfectly consistent: short term self-interest was behind both the cries for deregulation and for re-regulation. The rhetoric was merely to help 'sell' the changes.

This example introduces the major thesis of my chapter: that whatever the professed rationale, proposed changes in the regulatory *status quo* usually seek to transfer income to the proponent at the expense of others. If it is currently beneficial to introduce deregulation, it will be demanded; if the gain lies in regulation it, too, will be sought. In either case, as a consumer, whenever I hear someone ask for more or less regulation I immediately reach for my wallet and hold it tightly.

Sometimes changing one aspect of the *status quo* may bring about the need to change others in the opposite direction. As we shall see, although competition and regulation are supposed to be alternatives, increased competition in telecommunications services will inevitably necessitate an *increase* in regulation. In some cases, privatising a Crown corporation may also require the introduction of regulation rather than deregulation. For example, Ontario Hydro, a provincially owned electrical utility, is not regulated but merely monitored by the Ontario Energy Board. If it were privatised, because it is a monopoly, its rates would have to be regulated.

## Competition

We start with competition because it is the ideal. In economic theory, competition is defined in terms of perfect competition. This means a market structure characterised by many competitive sellers, with each participant lacking the market power to establish industry price and output. In a competitive marketplace the existence of abnormally high profits in an industry provides incentives for others to compete. Through the 'invisible hand' of the market, this competitive entry will increase the output of the industry to the point where the price of the goods or services is driven down to the economic cost of production. This solution is regarded as optimal because there will be no long-run profitability in any industry, with consumers simply paying the economic cost of production for the goods they consume ('cost' here includes the cost of capital which includes a reasonable dividend and chance of capital appreciation for the shareholder).

Most of us recognize that conditions of perfect competition do not exist anywhere. In the Canadian manufacturing sector, industries are typically characterised by four or five dominant firms which account for up to 80 per cent of total output. Examples would include the pharmaceutical industry, oil and gas, banking and a variety of others. Furthermore, with our very weak competition laws, the absence of US-style treble damage civil suits for over-concentration and very limited resources for enforcement, there are no effective safeguards in place to ensure that vigorous competition is the norm in the unregulated sectors of the economy. As our Royal Commission on Corporate Concentration concluded:

> free markets composed of many smaller firms which cannot influence price at which their output is sold, have probably never existed in a modern, industrial economy. The Canadian economy, though widely thought to be a free enterprise economy, has always been composed of large firms and oligopolistic markets in many industries and has been characterized by extensive government involvement.[2]

The real question in the Canadian deregulatory debate, therefore, is often whether a regulated or an unregulated duopoly or oligopoly market structure is preferable to the regulated monopoly now in place. It is certainly not a question of a perfect competitive market replacing a regulated monopoly as the chosen market structure.

As for privatisation, in the United States there is very little government ownership of major corporations, with most regulation taking place through regulatory commissions. In the United Kingdom, state ownership of major enterprises has been much more common. To the extent that there has been privatisation in the United Kingdom, it has been supplemented by regulation, but in a much lighter-handed form than in the United States.

US-style regulation of telephone companies, airlines (formerly) and power utilities has involved virtually a surrogate management function in determining the maximum permitted rate of return on shareholders' capital, the rates to be charged to customers and all aspects of service quality and quantity. United States regulators are free to impute costs not actually shown on the books of account and to disallow costs which the companies have shown on financial statements when, in the opinion of the regulator, these costs were not necessary or prudent for the operation of the regulated business.

Canada has, in some cases, adopted the worst of both worlds. We have both state ownership and US-style regulation. Thus we have the typically Canadian phenomenon of a Crown owned airline appearing before a federal government regulatory agency (usually chaired by a former Cabinet Minister of the then governing party), with an appeal therefrom to the current Minister

or to the Cabinet. Such a situation does not exist in the United States or the United Kingdom. Needless to say, many commentators feel that this is over-regulation: there should either be Crown ownership or regulation, but not both.

The Canadian government is trying to create more competition in the airline industry. This is not as easy as it appears. Air Canada now has 60 per cent of the jet traffic in Canada. It has created a computerised reservation system, widely used by travel agents. This system books reservations so as to favour Air Canada. Air Canada has its own tour package subsidiary (which offers low-priced vacation packages on its routes), its own credit cards, and well-integrated contractual relationships with a host of hotels, car rental agencies and so on. It also has the best gate and counter locations at most airports. It will be difficult enough for established Canadian airlines to compete with it, let alone new, fledgling carriers. Perhaps that is why, in anticipation of deregulation, several of the other major airlines in Canada have merged so that today, Air Canada has at least one major domestic competitor, Canadian Airlines International Ltd., with other smaller ones such as Wardair, waiting for the opportunity to expand when deregulation is introduced.

The difficult question is whether to deregulate and allow these competitors to compete, running the risk that the dominant company will relatively quickly crush most of the competition, or whether to 'level the playing field' to give the weaker ones a better chance. When we start a new race, shouldn't everyone start more nearly at the same starting point?

It has been suggested that Air Canada be required to divest itself of its reservation system, and have its growth in routes and number of aircraft frozen for the first five years after deregulation to allow competitors to develop their own asset bases and level of public recognition to enable them to compete. The dilemma is that if nothing is done, under deregulation Air Canada may well become even more dominant (assuming that we continue to keep out non-Canadian competitors); if we 'level the playing field' the result may be equally disastrous. That could be the consequence of weakening the strong to strengthen the weak. On a world scale, this reduces Air Canada's ability to compete internationally. At home, it may make the entire industry, on average, less efficient as it may diminish economies of scale and scope. This would also encourage traffic to move from what may be the more efficient operator to the less efficient ones, precisely the opposite of what market forces should achieve. Finally, having taken this gamble, what happens if these less efficient companies cannot, despite competition, achieve the economies of scale and scope that Air Canada had originally? Or, as in the United States through mergers, another dominant carrier is created which may be no more efficient than Air Canada was? This kind of highly disruptive industry restructuring is very costly for the industry, without even considering the externalities. What price competition?

Is competition the means to an end or the end itself? By breaking up an efficient, vertically integrated operator will we increase the amount Canadians spend on air travel without increasing what they get for it? This would result from a lower productivity of capital – the opposite of what the market is supposed to achieve.

It takes a great deal of faith in competition to gamble that weakening the dominant player will, in the long run, enable the two or three competitors for which there may be room in the market to generate more than offsetting gains. Indeed, any tampering with the *status quo* in what superficially appears to be a more conservative, market oriented direction is a very risky process. The probability that politicians and their public service advisors will correctly identify the future market conditions under which the greatest productivity gains may be achieved is not very high.

Nowhere is the decision about competition more difficult than in the telecommunications area. Terminals (that is, telephone sets and switchboards) were deregulated several years ago, both in the United States and in Canada. This has been a great success because the telephone companies had no natural monopoly over these. It has led to the assumption that no part of a telephone company is a natural monopoly any longer and that competition generally is a good thing for the industry. Now there is increasing pressure in Canada to allow 'competition' in telephone transmission, particularly long distance services, to catch up to the situation south of the border. This competition is called 'interconnection' or 'interexchange competition'.

What would-be competitors generally do not mention is that they are not themselves telephone companies seeking to compete with established telephone companies to provide the same service: end to end transmission. They own little or no telephone equipment. They want to sell to present and future customers of telephone companies, at a lower price than the telephone companies, what are essentially telephone company services, using the facilities and equipment of the telephone companies and paying very little if anything for them. The only thing that makes such balled competition possible is that the regulator will force the regulated company to provide its facilities at a price low enough to allow the competitive service to be marketed and still to make a profit. There are few efficiency gains achieved. The result is only lower prices for some customers at the expense of others: simple transfer of income, a zero sum game.

Such a service offering might start with an entrepreneur collecting a group of large users of the service who wish to obtain lower long distance rates. Alternatively, the large users may simply incorporate an association and find themselves a vendor in the form of another telecommunications company. In any event, someone applies to the regulator for the right to 'interconnect' its rather limited equipment to the major switched telephone network, at a price

that makes it worthwhile for vendor and customers alike. At the public hearing held by the regulator there is then much rhetoric about the benefits of greater competition, and enthusiastic monopoly-bashing, usually supported by the Bureau of Competition Policy, a part of the Federal Department of Consumer and Corporate Affairs. In the end, if the effort is successful, the other customers will be required to make up the loss of revenue to the telephone company.

A hypothetical illustration, using another industry, shows the absurdity of this pseudo-competition. Let us say that someone wanted to compete in the passenger rail industry, not by running trains in competition with others but by providing a bar car on trains owned by others. This entrepreneur would apply to the regulatory agency for the right to sell drinks at prices below those charged by the regular carrier.

A major cost inquiry would be held to determine how much the service of drinks costs the railway. This is not so easy to calculate. The labour and material costs are simple enough, but what proportion should the bar car bear of the cost of the engine and its fuel, the maintenance of the track and railbed, and head office costs? If one used a marginal costing technique this would assume that the train was travelling in any event and that the bar car was the incremental car; in that case its share of these costs would be virtually zero. If one used a fully distributed costing technique this would assume all the cars are travelling together and would assign each a proportional share of the total cost of that train; in that case the cost allocated would be much higher. Each technique has its strong supporters and detractors. After much argument, the tribunal would eventually set a price for the carrier's drinks and a (presumably) lower price for the competitor's drinks.

The competitor would then argue that since the train was running anyway, the cost of pulling the extra bar car was negligible; therefore, there should be no charge for adding the bar car. The railway would argue that the true cost was replacement cost, so the charge should be equal to the cost of buying or leasing an engine and crew just to pull the bar car. Of course, this would make the service uneconomic. The regulator could select either position, or anything in between, but as there is no single accepted technique, the choice of costing method is arbitrary. Yet the choice of costing method determines the price, which in turn determines the existence or non-existence of the proposed service. Since costing data can be made to show virtually anything, the regulator has total discretion to do as it wishes.

The entrepreneur's arguments sound ridiculous in the context of trains, yet they are heard commonly in telecommunications. The fact that would-be free riders are not seen as ridiculous in telecommunications is because we are so blinded by our ideological commitment to competition that we fail to recognise that interconnection managed by regulators is not the same as free market competition.

The result of this so-called competition in telecommunications has been, in many cases, that well-documented evil, cream-skimming. This consists of someone providing competition only in the most lucrative geographical areas or for the most profitable services. CNCP Telecommunications, which applied (unsuccessfully) for interexchange competition with Bell Canada, wanted to compete only in a few major markets, while Bell Canada would continue to provide service to all the much more costly to serve outlying areas. Moreover, it structured its services so as to appeal only to the largest customers – presumably those who are the least costly to serve and, therefore, the most profitable. If such cream-skimming had been allowed, the result would now be much higher rates for other customers. (CNCP's application was supported by large user organisations and the Bureau of Competition Policy.)

One might expect that the telephone companies are opposed to interconnection. In practice, however, they are not. That is because they know that regulatory agencies will ensure that they earn the same rate of return no matter what happens. If they earn less from long distance services they will be allowed to make up the difference from the basic monthly rates. This can actually result in a subtle, but real advantage. Since long distance services are the ones most easy to compete with, competition will tend to drive down prices and profit margins for those services. This makes earnings volatile, which has a negative impact on share prices. The higher the percentage of revenue from basic local service for which demand is inelastic, the greater the revenue stability and, therefore, the higher the share prices.

Under true competition, which does not and cannot exist for end to end transmission, telephone companies would have reason to be concerned; however, under interconnection even the regulated company may be slightly better off. This is for two reasons: First, the 'guaranteed annual income' tendency of regulation in these circumstances and second, the fact that the regulator rather than the marketplace is really making the crucial decisions. Under normal market competition, the market decides who gets what market share. Under regulated competition this is determined by the regulator who sets the price that must be charged by both the utility and its competitors. This is necessary because unless the regulator sets prices the regulated utility will start a price war which only it can win because it has a huge base of monopoly customers from which it can fund its low pricing while its competitors do not. To prevent this, the regulator must set the price for everyone, with the competitors' prices set below the prices of the telephone company, to give customers an incentive to switch; otherwise there can be no competition. The spread between these prices determines the relative sales volume and, thus, the market share of each. There is no economic theory which tells a regulator how to set these prices. It is purely arbitrary.

In addition, the price for interconnection paid by the competitors to the utility must also be set by the regulator. There is no objective way to determine the cost of interconnection, hence no way to base this price on cost. It, too, is arbitrary.

These problems are vividly illustrated in the United States today. As the interconnection price AT&T is required to pay to the local Bell operating companies is being lowered by the regulator to a level closer to that now paid by AT&T's competitors, the latter are finding it increasingly difficult to survive. This suggests that there may in reality be no room for any competition in the market and that AT&T may have been right when it said that end to end transmission is a natural monopoly. The assumption that the very positive experience with competition for terminals can be translated into competition for transmission is probably false. If that turns out to be the case – if American regulators have underestimated the economies of scope and scale – then this policy to create competitors through structural separation and forced interconnection may have been a colossal blunder. The breakup of AT&T and the regulatory encouragement of the massive investments by MCI and others in duplicating AT&T's long distance transmission equipment has probably resulted in very wasteful excess capacity, much of which will remain under-utilised. Indeed, it would not be surprising to discover today that the average American (and perhaps soon the average Canadian) will be paying more for essentially the same or a lower quality of telephone service than before. It will also take much more capital to provide only a relatively small increase in level of service, thereby using this capital inefficiently.

The FCC may, ironically, be forced to increase prices to help keep its 'children', MCI and Sprint, alive. This would raise AT&T's rate of return far higher than it should be. Yet if the weaker competitors are to be kept alive the rates of all must be set high enough to preserve the least efficient, not so low as to be fair only to the most efficient. This policy of protection of the 'lowest common denominator' provides a windfall to AT&T, at the expense of its customers, which are about 85 per cent of the market.

Paradoxically, although the end result may be unsatisfactory, the policy has worked to achieve its intended goal: more competitors. The paradox reveals the confusion between ends and means. The end should have been greater efficiency, not more competition. When competition itself is the end it requires all sorts of teleological reasoning and highly arbitrary decisions as to how to 'level the playing field' to create more equal conditions, which new services should be allowed, at what prices, and so on. For regulators to fail to understand that what they are doing is taking the lid off Pandora's box would be sheer ignorance; to understand, but to do it anyway is hubris.

The coterie of politicians, academics and journalists who support the regulators' efforts to create competition in telecommunications fail to recognise the difference between real, head to head competition and

interconnection. One wonders whether the competition advocates who support it for conservative ideological reasons would still favour 'competition' if they knew it meant, as well as higher prices, more intrusive and much larger regulatory bureaucracies. It is rather difficult to apply conservative ideology to public utilities because it is hard to know what to conserve: more competition means more regulation, but less competition means more monopoly. In the real world, as opposed to the ideal, that is the choice.

It is interesting to observe the origin of these cries for more competition in telecommunications. They come primarily from those heavy users sufficiently astute to discern that during a period when rapid technological change causes declining unit costs, it is possible to obtain telephone service at a much lower price if one can persuade regulators to create, through the vehicle of interconnection, what is essentially a lower rate for substantially the same service, without the rest of the customers noticing it. In this way, the savings that result from lower unit costs in the industry are not shared equally among all customers, but captured by a few. The rest never notice because, although their rates do not come down (this is such a rare occurrence that it would not be expected), their rates do not increase either. When this redistribution of income is 'packaged' in the wrapping of more competition, decorated with the glitter of patriotism – 'it will help us to sell our products and services internationally to bring in greater export revenues' – it becomes politically almost irresistible. It is certainly a lot easier for a special interest group to obtain a benefit this way than to try to do it overtly, for example, through seeking a direct government grant or a change in the tax system. Yet the end is precisely the same: a favourable redistribution of income at the expense of others.

Regulation and competition are supposed to be opposites. There is no need to regulate when markets work. Yet, as already noted, with interconnection it is the regulator much more than the marketplace that determines which businesses shall be winners and losers and, by setting all the transfer prices and selling prices, controls even who shall be the entrants. This results in a massive increase in regulatory intervention, by ever larger and more powerful regulatory bureaucracies. Regulators, too, enjoy this kind of 'competition'.

In North America an entire regulatory service industry has arisen. It too benefits greatly from changes, or even proposed changes to the *status quo*. Whatever the direction of the proposed change, hearings must be held, evidence prepared and arguments submitted. This creates movement, activity and wealth for the small army of executives, accountants, economists and even (perish the thought) lawyers who do very well at these hearings.

Everyone is a winner but the vulnerable, unorganized consumer for whose protection the regulatory system was intended. The new 'competitor' may be granted what is, in effect, a license to sell, with regulated price protection, the

services of a telephone company as is or slightly enhanced, at minimal cost to itself. The telephone company is made whole by the regulator, which raises rates to other customers to equalise the company's rate of return. The tribunal and departmental bureaucracies grow in size and power. And the customer who has no alternative foots the bill.

Perhaps the ultimate irony is that competition is invoked because it is preferable to regulation. Regulators, it is argued, cannot be trusted as much as the marketplace to improve efficiency and responsiveness to consumer demand. Because of the failure of the market we needed to introduce regulation; now, because of the failure of regulation we need to reintroduce competition. If the tribunals which regulate telephone service[4] are incompetent at the relatively simple task of setting the rates of a single telephone company in isolation, why are these same tribunals better qualified for the much more complex task of setting not only these rates but, also, the relative rates of several competitors, as well as the rates the latter must pay for the use of the telephone company's equipment? Why, if regulation is an evil, is much more regulation a virtue? Logic counts for little when self-interest and ideology converge.

The regulator's job is to pressure monopolies into behaving efficiently when the marketplace doesn't exist. If it is not doing this properly because it lacks adequate tools, the answer lies in more resources or better legislation. If the regulator has the tools but isn't using them, personnel must be replaced. But to create a new hothouse 'marketplace' and then give the same regulatory system much greater responsibility destroys the logic of trying to achieve greater competition.

## Regulation and Deregulation

In North America, regulatory agencies regulate the quality of service, the level of service and profit (rate of return). This necessitates control of important ancillary factors such as rate design (i.e. the different rates charged to different customer classes), the rate of introduction of new technology and new services, and accounting for regulatory purposes. The latter is perhaps the most difficult and controversial area of all.

In the few industries in which price only is regulated – cable television and, soon, pharmaceuticals – control tends to be much less effective. It assumes that the prices in effect when regulation is introduced are correct and only changes need to be monitored and perhaps adjusted. Even more important, it assumes that the profit earned by the regulated entity is no more than reasonable, both before regulation and thereafter. This is to assume that profit is irrelevant in businesses run for profit.

Since the basic rationale for economic regulation is to protect the public from the inefficiency and abuse of monopoly power which might occur without regulation, this objective cannot be met unless profits are regulated. An enterprise whose prices only are controlled may have rates much higher than they should be, yet will be allowed to continue to earn excessive profits simply because the prices charged to customers are not changing more rapidly than the consumer price index (or some other such benchmark). The consumer price index is irrelevant to most utility rates because the 'basket' of goods and services represented by the CPI is not at all like that consumed by the regulated entity. This makes it likely that excessive rates and inferior service quality will persist, with little the regulator can do to control them. Price regulation is a monitoring exercise, not to be confused with effective regulatory control.

That is not to say that rate of return regulation is perfect. When its application is heavily tainted by extraneous factors such as political pressures, its results may make little economic sense. In regulatory theory this sort of thing is not supposed to happen. The regulator, which acts as a surrogate for the marketplace, should punish the shareholders of those companies with substandard performance by allowing them only substandard returns, forcing management to improve rapidly for fear that the shareholders will replace them. However, when we are dealing with a Crown corporation which has no shareholders, this theory breaks down.

The situation is further complicated when costs have been imposed upon a regulated Crown corporation for political reasons. For example, some have been pressured to accept very unfavourable collective agreements with unions; others, to duplicate maintenance facilities and accounting offices to appease regional sensitivities and create local employment; still others, to purchase from domestic suppliers, even if at higher cost.

Nevertheless, in the overwhelming majority of cases, rate of return regulation will tend to work better than mere price regulation. All of the same political pressures can also exist with price regulation, but, as well, price regulation has special pressures of its own.

If a price regulator refuses to provide a price increase sought by the company, the latter can then justify to the public its decrease in service on the basis that it has less revenue. Because its profits are not examined, no one can determine whether the decreased revenue results in a substandard profit so as to justify the cutback or whether it is merely defiance of the regulator. When angry customers are pressuring politicians because their service is deteriorating the pressure will very quickly be transmitted to the regulator. Since price regulators know this, they will tend to fear any confrontation with the industry , as that can reduce service. Who is really in control, one might well ask?

By way of contrast, several years ago when New York's telephone regulator found service to be substandard, it lowered the company's allowed rate of return. The regulator indicated this would continue until service quality was improved. This tough stand was taken despite the utility's argument that the reduced return made it more difficult to improve service quality. Eventually the company gave in, pulled in its belt and improved the service. Profit levels were restored. This example shows that the only effective weapon any economic regulator has is the ability to hurt the shareholders, who will then pressure management. It can do this only if it has the power to make orders linking profits to performance.

Of course, there will always be a tendency for regulatory agencies to live the comfortable life, to have these powers but not to use them. It is much easier simply to rubber stamp the company applications year after year, perhaps pruning a bit here and there, than to enter into stressful confrontations about the books of account, cost of capital, the necessity for numerous construction projects and service quality. A discussion as to when regulatory agencies will work and when they will coast has been the basis of more than one interesting book, but it is certainly beyond the scope of this chapter.

Canada has had rather limited experience with deregulation. Only two examples come to mind: airlines and natural gas. Airline deregulation is at the legislative stage. Natural gas deregulation is under way. Both of these are being introduced in large measure because they have been deregulated in the United States. Much lower airline and gas rates just a few miles across the border create strong pressure to follow suit.

Deregulation, interpreted literally, implies the elimination of regulation. This is impossible; there is no such thing as a totally unregulated industry. When we talk about airline deregulation, no one is suggesting that airlines be able to hire unlicensed pilots or fly aircraft which do not meet strict standards. Safety will not be deregulated. Entry and pricing will be.

Apart from the narrow context of 'paper burden', deregulation is not so much a quantitative as a qualitative concept. To talk of more or less regulation is too vague. We have to ask 'what is it that is now regulated that should be deregulated?'.

For the airline industry, anyone with safety-approved aircraft and licensed pilots will be able to provide service at any price on any route, without requiring permission from anyone. One can also stop providing service between any city pair on thirty days' notice .

Perhaps the furthest advanced deregulation now taking place in Canada is of natural gas. As gas prices have tumbled along with oil prices, we now have a temporary surplus of gas (unfelicitously referred to as the 'gas bubble').

The pipeline companies which have been transmitting this gas from Alberta to the large eastern markets have long-term contracts with gas producers. However, producers are anxious to sell more gas to get rid of their surplus,

preferably without cutting the prices on their longterm contracts. It is now possible for a large gas user to buy gas more cheaply directly from Alberta than the pipeline company itself is paying under its long-term contracts. Accordingly, certain very large users of gas (mostly in Ontario) want to purchase directly. They have persuaded the federal and provincial governments to deregulate the price of gas. This has resulted in the pipeline companies unbundling their rates for gas purchasers and transmission-only customers. Large users can now purchase gas directly from producers and pay the pipeline company to carry it to their own facilities or to a local distribution company which will carry the gas the rest of the way to the plant.

Small industries and residential consumers cannot use sufficient volume to make it worthwhile to contract directly with producers. Also, the Province of Alberta refuses to allow direct sales to anyone who is not an industrial user, to protect its so-called 'core market' (read: captive market) prices. The local distribution companies and pipeline companies will remain locked into these long-term contracts, and will buy gas at a higher price than the current market price paid by industrial consumers in Canada, and even than export customers in bordering US states, whether industrial or residential. Today, Canadian residential consumers pay $3 per thousand cubic feet whereas those across the US border $1·80 (in Canadian dollars). This is the result of a deregulation accord reached with the Federal government, which, in the name of competition, abandoned the small business user and residential consumer to the mercy of the producers.

The Province of Manitoba attempted an interesting test case before the National Energy Board to determine whether it can act as a representative of its residential consumers and purchase gas directly, thereby ending price discrimination in favour of the industrials. The NEB rejected Manitoba's application.

The important point to note, again, is that the primary reason for gas deregulation has not been economic efficiency (although it has allowed some smaller, formerly excluded gas producers to sell their gas in competition with the majors). Rather, it is to give large customers which have alternatives a price advantage over those who need the protection most. Again, this has been justified on the basis of improving the competitiveness of those industries with heavy usage patterns. While this policy may have its benefits, no one has measured its costs or determined whether there is any net advantage to the economy. No one knows whether the winners under deregulation would gain more than the losers would lose.

In perhaps five or ten years' time, when the bubble is gone, the large users will want to stop buying gas directly and come back on the system. Today, when prices are falling, they want to be treated as the marginal customer; when the spot price of gas rises above the long-term contract price available

through the utilities, they will want to be treated as the average customer.

There is no philosophical commitment to deregulation in all of this. In the short run, it serves the benefit of providing temporarily lower prices to some and, thus, a redistribution of income. When it no longer serves that purpose, when the benefits of regulation again outweigh the benefits of deregulation, the latter will be abandoned.

It is interesting to observe that when oil prices were rising, producers were demanding deregulation of oil; when gas prices were falling, they demanded deregulation of gas. This shows that which way the prices are moving is unimportant; likewise, whether the change is from regulation to deregulation or *vice versa*. What matters is only that the group demanding the regulatory change benefit from it.

It is also noteworthy that whether it is telecommunications or oil or gas, producers usually favour their largest customers. That is because only these users have the economic and political clout, both individually and through powerful trade associations, to exploit successfully the rhetoric of deregulation, competition or whatever, to overcome the legislative, bureaucratic and regulatory inertia and, thus, to change the *status quo*. Neither heavy users nor producers may be able to change the *status quo* over the objections of the other, so they usually have to work together for mutual benefit. Faced with this strong united front, regulators and governments tend to give in.

One of the arguments used by the utilities is that if these price concessions are not made, the large users have alternatives available to them and will simply bypass the system; to recover anything above marginal cost is a benefit to all consumers. Recent studies in Canada[5] and the U.S[6] have shown that the bypass threat, at least in the telephone industry, has been greatly exaggerated. This may also be the case with energy utilities. Often the prospective bypassers have, for tactical reasons, understated their cost of bypass but, where bypass truly would be efficient, the rational course would be to let them go.

## Conclusion

It is not very helpful to generalise about the benefits or evils of competition, deregulation or privatisation. These can be 'good' or 'bad', depending on the particular case, including:

i. Whether one agrees with the objectives sought to be achieved, both stated and unstated (such as economic efficiency, job creation, competition, raising capital to reduce the deficit, weakening unions, disciplining corporate management, and depoliticisation of economic decisions).

ii. The industry structure before and after the change (monopoly, oligopoly, effective competition, effective regulation)
iii. The presence or absence of natural monopoly conditions
iv. Whether the benefits and costs are felt simultaneously, or whether they occur at different times.

Cries for regulation or deregulation, or more competition or less competition are not motivated merely by an attraction to good economics or sound public policy or even ideology. They reveal an alliance between utilities and heavy users of their services. The latter will be the principal beneficiaries of a rate change which has the effect of redistributing income, although the utility benefits too.

If the potential benefit is large enough and the change-seeker well enough organised (as contrasted with the mass of small consumers, who are not), a high-sounding call to economic principle will provide the diversion which allows the ordinary consumer's pockets to be picked. The industry's argument will tend to be repeated, and thus, reinforced by sympathetic academics who are quick to support 'cost based pricing' or 'greater competition' without looking behind these cliches to see who is really doing what to whom. A generally uncritical media is all too happy to quote 'industry observers' or 'reliable sources' – usually stock analysts at large brokerage firms which benefit from underwriting and sales commissions on selling these utility stocks. In the case of Bell Canada, for example, which is wholly owned by Bell Canada Enterprises (1986 total revenues of $13.9 billion, total assets of $23.7 billion) every major brokerage firm in North America is eager to curry favour. The telecommunications analysts at the various brokerage firms compete with each other to be quoted by the press as saying the most favourable things about the company.

Regulation, deregulation, competition and Crown ownership all exist side by side in the Canadian economy. An attempt to change from one regime to another is an attempt to make new rules so as to obtain a larger share of society's wealth. Only when we understand it that way can we begin to ask who is trying to do what, to whom, and for what gain. Who will be the new winners and losers? Stripped of economic theory and the ideological wrappings, naked self-interest is much easier to understand.

## Notes

1. *The Citizen and the State*, Chicago 1975, p.183.
2. *Report of the Royal Commission on Corporate Concentration*. Canadian Government Publishing Centre, Supply and Services Canada, Hull, Quebec: March 1978, page 2.

3. Canada has just reversed its policy of compulsory licensing of generic manufacturers of pharmaceuticals in Bill C-22, presently before the Senate.
4. The Canadian Radio-Television and Telecommunications Commission (CRTC) for Bell Canada and B.C. Telephone and the various provincial public utilities boards for the other companies.
5. *Federal-Provincial Examination of Telecommunications Pricing and the Universal Availability of Affordable Telephone Service*, Report, Minister of Supply and Services Canada, 1986, at p. 46:

   > The current extent of bypass of telecommunications carriers' facilities, both domestically and internationally, has been found to be minimal. Bypass is deterred by current pricing principles and practices as well as by the radio spectrum licensing, interconnection and other policies of the federal and provincial governments, and by Canada-U.S. exchange rate differentials. Removal of some or all of these deterrents could result in increased by-pass activities in Canada.

6. 'US Telecommunications Policy and Deregulation – panacea or premature solution', Bolter, W.G. and McConnaughey, J.W., in *Telecommunications: National Policies in an International Context*, Communications Policy Research Conference, proceedings, Garnham, N. (ed.), Polytechnic of Central London, 1986, p. 105. The authors conclude, at p.110:

   > In short, bypass...is currently not a problem of monumental proportions. Such activity is on the rise, but a substantial part of the solution for exchange carriers lies in their ability to meet the non-price requirements of users. As such, there would seem to be no need for US policy makers to stampede to a full deregulatory prescription at the present.

# Privatisation and Deregulation in Britain

Edited by Jeremy Richardson

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# Post-Secondary Education in the World

[illegible] Jeff Greenbe

*Published in association with the Institute for Research on Public Policy, Ottawa*

In this book authors from the United Kingdom and Canada examine how post secondary education in their two countries is [illegible] with new developments such as the changing role of government in providing education and training, the needs of the information society, the role of commercial enterprises, and post secondary education as investment in the future. Even though the starting points and traditions are somewhat different, many problems are common to the United Kingdom and Canada, and it is clear from the papers that appear in this collection that much can be learnt from sharing experiences.

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